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Report vol. 3

1966

REPORT

OF THE

ROYAL COMMISSION ON

TAXATION

VOLUME 3

TAXATION OF INCOME

Part A Taxation of Individuals and Families

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CANADA

REPORT

of the

ROYAL COMMISSION ON TAXATION

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ROYAL COMMISSION ON TAXATION

VOLUME 3

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PART A

TAXATION OF INDIVIDUALS AND FAMILIES

CHAPTER 7

TAXATION BASED ON ABILITY TO PAY

For centuries men have been seeking some general principle that could be used to apportion the burden of taxation in an equitable manner. Two streams of thought have emerged from this great debate. The benefit approach postulates that equity is served if taxes are apportioned according to the benefits derived from government by particular individuals, or groups of individuals. Under this approach, taxes are treated as a payment for the goods and services provided by the government. If these goods and services reflect the wishes of the people, so goes the argument, the imposition of taxes on those who benefit can be treated as a fair exchange, similar to the exchanges that take place in the market. The other train of thought, the ability-to-pay approach, largely ignores what the government provides to the members of society by way of goods or services, and takes the position that taxes are equitable when they are levied according to a defined tax capacity, or ability to pay, of individuals or groups.

It will be amply evident from earlier statements made in this Report that we favour very strongly the ability-to-pay approach. The benefit approach in our view has very serious practical and theoretical deficiencies 1/. In a few areas of public expenditure where a very close relationship can be established between outlay and benefit, a specific levy may be appropriate. The most obvious example is that of the gasoline tax imposed to support highway expenditure, and to some extent the real property tax where some of the services provided by a municipality are of direct benefit to the owners of property. But the list of such instances is short. A careful examination of the goods and services provided by government or government enterprises does not suggest that greater emphasis should be placed on the benefit approach in Canadian taxation. We base this conclusion on three considerations:

1. The redistribution of purchasing power, which we believe to be an important function of government, would be precluded if all public expenditures were financed by taxes levied according to the benefits received, if benefits are narrowly defined. It is the people with the least economic power who are most in need and benefit most from public expenditures. If the benefit approach were applied exclusively, the more the government did to help this group, the more it would have to pay in taxes. The whole transfer process would thus be frustrated.

2. There are many expensive government services that bestow benefits that cannot be allocated to specific individuals in a generally accepted manner. For example, to assert that a particular individual must pay a certain proportion of the nation's defence bill, because it had been decided that he had enjoyed that proportion of the benefit, would be outrageously high-handed.

3. Some government goods and services, such as education, provide benefits that accrue partly to the users and partly to society as a whole. There is no problem in assigning some of the benefits to the actual users of such government services, but there are serious problems in trying to determine the relative importance of the direct and indirect benefits. Furthermore, the allocation of the indirect benefits among all the people would pose the same problems as the allocation of the benefits from such things as defence expenditures. Any assignment of indirect benefits would be completely arbitrary and, we believe, capricious. Indeed, because some of the indirect beneficiaries may live outside our tax jurisdiction altogether, the complete allocation of the indirect benefits would be futile.

The other concept, taxation according to ability to pay, is inherently as arbitrary as the benefit approach, in the sense that the fundamental propositions on which it is based cannot be proved or disproved. There is, however, an important difference. We do not believe there is an equitable

method of allocating taxes according to the benefits of government expenditures. There are, however, principles that we believe provide a fair basis for the allocation of taxes according to ability to pay. We can do no more in designing a tax system than found it upon these principles.

In a democracy, equity questions ultimately must be resolved in terms of the shared values of the people. There is no higher authority. It is our earnest hope that the ability-to-pay principles in which we believe, and from which we have derived our major recommendations, commend themselves to most Canadians.

DEFINITION OF ABILITY TO PAY

In our judgment taxes should be allocated among tax units in proportion to their ability to pay. We believe this would be achieved when taxes were allocated in proportion to the discretionary economic power of tax units. This statement is only meaningful if the term "discretionary economic power" is defined. For this purpose we have found it useful to think of discretionary economic power as the product of the tax unit's total economic power and the fraction of the total economic power available for the discretionary use of the unit. By "tax units" we mean families and unattached individuals. By "total economic power" we mean the power of a tax unit to command goods and services for personal use, whether the power is exercised or not. By the "fraction of the total economic power available for discretionary use", we mean the proportion of the unit's total economic power that does not have to be exercised to maintain the members of the unit. Maintenance is not synonomous with bare, physical subsistence. Rather, it denotes the provision of the services necessary to maintain the appropriate standard of living of the family or unattached individual relative to others.

Later in this chapter we discuss the concept of total economic power. But to be able to derive the major implications of our ability-to-pay principles, we can anticipate that discussion and say that we believe the

total economic power of tax units, relative to one another, can best be measured over time by the adoption of what we have called a comprehensive tax base. This base would constitute a great broadening of the present income tax base, but for expository convenience we call the base "income". It should be borne in mind, however, that our concept of "income" encompasses much more than the present tax base.

To be more explicit about the concept of ability to pay, we believe the allocation of taxes in accordance with ability to pay requires adherence to five fundamental principles:

1. Families and unattached individuals should be treated as the basic tax-paying units, that is, the entities with potential ability to pay.

2. Taxes should be allocated among tax units in proportion to ability to pay. Specifically, the tax allocated to unit A should bear the same relationship to the tax allocated to unit B, that the ability to pay of A bears to the ability to pay of B.

3. The ability to pay of a tax unit should be assumed to be proportionate to its discretionary income. In other words, the ability to pay of unit A should be assumed to bear the same relationship to the ability to pay of unit B, that the discretionary income of A bears to the discretionary income of B.

4. The discretionary income of a tax unit should be assumed to be equal to the total income of the unit multiplied by the fraction of that income available for the discretionary use of the unit.

5. It should be assumed that, other things being equal, the greater the income of a tax unit the larger will be the fraction of that income available for discretionary use.

The meaning of these principles can be clarified by a simple hypothetical example. Suppose that tax unit A has an income of $10,000, and

that one tenth of this income can be spent or not spent at the discretion of A. Suppose further that B has an income of \$20,000 and two tenths of this income is available for the discretionary use of B. According to our ability-to-pay principles the relative taxes imposed on A and B should be as follows:

$$\frac{\text{tax on A}}{\text{tax on B}} = \frac{\text{income of A} \times \text{fraction available for discretionary use of A}}{\text{income of B} \times \text{fraction available for discretionary use of B}}$$

$$= \frac{\$10{,}000 \times 0.10}{\$20{,}000 \times 0.20}$$

$$= \frac{\$1{,}000}{\$4{,}000}$$

From this calculation it follows that the tax on B's income would be four times the tax on A's income. If a total revenue of \$1,000 is to be raised from A and B, the rate of tax on the discretionary income of each unit should be 20 per cent (that is, 20 per cent of \$1,000 and \$4,000).

This example perhaps gives a misleading impression of precision of the principles we espouse. To apply these principles, the concept of income must be defined and applied on a consistent basis. Furthermore, the fraction of a tax unit's income available for discretionary use is not an objective phenomenon. It can only be determined on the basis of judgment. But the foregoing principles have the virtue that they make our fundamental beliefs explicit and provide a framework within which judgments can be made.

Once an income tax base is established that measures the relative total economic power of tax units, an equitable allocation of taxes among units would be achieved when fair and reasonable judgments were made about the relative differences in the fractions of income available for discretionary use in different circumstances. In our opinion the following three factors should be recognized:

1. Differences in income.

2. Differences in family responsibilities.

3. Differences in certain specific non-discretionary expenditures.

We will briefly discuss how each of these circumstances should be taken into account.

Recognition of
Differences in Income

As stated above in the fifth ability-to-pay principle, we believe that the level of a tax unit's income and the proportion of that income available for discretionary use are not independent. Other things being equal, the greater the income of the unit the greater is the fraction available for discretionary use. As illustrated in the foregoing example, we believe a tax unit with an income of $10,000 has a smaller proportion of that income available for discretionary use than an identical family with an income of $20,000.

This general principle must be supplemented by two additional assumptions in order to derive precise rules for allocating taxes among tax units in proportion to their respective abilities to pay. We believe that the following assumptions give fair and reasonable results:

1. All income of a tax unit in excess of some amount is assumed to be available for discretionary use. We have taken this amount to be $100,000. 2/

2. Below this limit, equal proportionate differences in income are associated with equal absolute differences in the fraction of income available for discretionary use 3/.

The first of these assumptions constitutes an implicit rejection of the belief that non-discretionary expenses are those necessary for physical

subsistence, for the subsistence approach would imply that non-discretionary expenses do not change with income. This in turn would call for the application of a constant rate of tax to a base consisting of total income less a fixed exemption. We believe that most non-discretionary expenses increase, although not proportionately, as income rises.

The second assumption is the simplest we could make that was consistent with our belief that the fraction of income available for discretionary use rises rapidly at the lower end of the income scale, and that upper middle income tax units have a substantial fraction of their income available for discretionary use.

Although there are various methods that could be adopted to allocate taxes in accordance with the foregoing principles and assumptions, one method of achieving an equitable result under an income tax would be to establish an ascending schedule of proportions of income that would represent discretionary economic power, and then subject these to a proportional tax. However, a more familiar method to achieve the same result would be to apply to a base that measures the total economic power of each tax unit a schedule of progressive rates of tax. We believe this schedule of rates should have the following characteristics:

1. The top marginal rate of tax is reached at an income of $100,000.

2. Brackets encompass equal percentage differences in income.

3. Marginal rates rise by equal amounts from bracket to bracket.

4. The top marginal rate is consistent with revenue requirements.

In Table 7-1 we have drawn up a hypothetical rate schedule consistent with our ability-to-pay principle to illustrate what is involved. The following assumptions are contained in the table:

1. The assumed rate of tax on discretionary income equals the top marginal rate of tax.

2. The marginal rate of tax on the income in each bracket equals the top marginal rate of tax multiplied by the assumed fraction of income in that bracket available for discretionary use.

3. The marginal rates are predetermined once the rate of tax on discretionary income, the lower limit of the top bracket, the number of brackets, and the discretionary income fraction for each bracket have been established.

4. It should be stressed that this rate schedule is hypothetical and is intended only to show the operation of the principles we have developed concerning ability to pay. A number of other objectives and constraints must be taken into account. These are discussed and proposed rates schedules are presented in Chapter 11.

It can also be seen from Table 7-1 that taxes can be allocated in accordance with our ability-to-pay principles in any of the following ways:

1. By the application of a uniform rate of tax to a base that measures the discretionary income of each unit (columns 4 and 5).

2. By the application of an average rate of tax to a base that measures the total income of the unit, where the average rate is greater the greater the total income of the unit (column 7).

3. By the application of progressive marginal rates of tax to a base that measures the total income of the unit (column 6).

The distinction that is often made between systems that impose tax at a constant rate, method 1, and systems that impose tax at progressive rates, methods 2 and 3, is not fundamental. By adjusting the base it is possible to achieve the same result in either way. The important distinction is

TABLE 7-1

A HYPOTHETICAL RATE SCHEDULE CONSISTENT WITH OUR ABILITY-TO-PAY PRINCIPLES

Income Bracket $	Assumed Fraction of Income in the Bracket Available for Discretionary Use	Discretionary Income: From Bottom to Top of Bracket $	Discretionary Income: Cumulative Total to Top of Bracket $	Tax on Discretionary Income at an Assumed Rate of 50 per cent: From Bottom to Top of Bracket $	Tax on Discretionary Income at an Assumed Rate of 50 per cent: Cumulative Total to Top of Bracket $	Marginal Rate of Tax on Income in the Bracket a/ %	Average Rate of Tax on Income at Top of Bracket b/ %
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
0 - 195	0.0	0	0	0	0	0	0.0
195 - 390	0.1	20	20	10	10	5	2.5
390 - 781	0.2	78	98	39	49	10	6.3
781 - 1,562	0.3	234	332	117	166	15	10.6
1,562 - 3,125	0.4	626	958	313	479	20	15.3
3,125 - 6,250	0.5	1,562	2,520	781	1,260	25	20.2
6,250 - 12,500	0.6	3,750	6,270	1,875	3,135	30	25.1
12,500 - 25,000	0.7	8,750	15,020	4,375	7,510	35	30.0
25,000 - 50,000	0.8	20,000	35,020	10,000	17,510	40	35.0
50,000 - 100,000	0.9	45,000	80,020	22,500	40,010	45	40.0
100,000 - 200,000	1.0	100,000	180,020	50,000	90,010	50	45.0

a/ Column (4) divided by width of the bracket or, alternatively the assumed rate of tax on discretionary income multiplied by column (1).

b/ Column (5) divided by the top of the bracket.

between systems that assume that discretionary income is a constant fraction of total income throughout most of the income range and those that do not. We are firmly convinced that the latter assumption is valid. We therefore reject proportionate taxation except for income in excess of a generous limit.

We stressed in Chapter 6 the great importance we attach to the redistributive function of the fiscal system. The adoption of a tax system that would subject a base that measures the total economic power of each unit to a schedule of progressive marginal rates with the attributes we have just specified would ensure that the costs of government transfers and expenditures were allocated among Canadians in proportion to their abilities to pay. Such a tax system, when combined with a progressive transfer-expenditure system that provided relatively greater benefits to low income families and individuals, would achieve the following results:

1. Low income families and individuals would become net beneficiaries of government.

2. Middle and upper income families and individuals would become net contributors to government.

3. The lower the income of the family or individual the greater the relative net benefit obtained from government.

These results are as they should be in a society committed to providing greater equality of opportunity and improving the well-being of those who have the least economic power.

Recognition of Differences in Family Responsibilities

Under the present tax system the individual is treated as the basic tax-paying unit. In our opinion this is too narrow an approach. We believe it is important that the tax system should recognize the existence of the family

as the primary social unit. Where there is a family, it is the discretionary economic power of the family, rather than of its separate members, that should be taken into account. In most families incomes are pooled, major decisions are collective, and responsibilities are shared. We therefore advocate a system that treats the family and the unattached individual as the basic units for taxation.

In our opinion, the family should be defined to include husband and wife and, with certain exceptions, minor dependent children. The incomes of the members of the family thus defined should be treated as a unit. Transactions between the members of the family should be ignored for tax purposes. Gifts from one tax unit to another should be brought into the income of the recipient unit. With the exception of certain gifts in support of close relatives, and gifts to recognized charities, the tax system should treat the making of gifts as a discretionary use of income. Therefore, units that make gifts should not have their taxes reduced relative to those that do not.

Although we are convinced that the incomes of all members of the family should be aggregated, tax units with the same total economic power do not have the same fraction of that power available for discretionary use when they have different family responsibilities. To be consistent with our ability-to-pay principles, the taxes payable by units with the same bases but different family responsibilities should reflect these relative differences. The family responsibilities affect the fraction that is available for discretionary use.

This raises three questions:

1. What differences in family responsibilities should be recognized by the tax system?

2. What is the relative difference in the fraction of income available for discretionary use between tax units with different family responsibilities?

5. What specific tax structure provisions should be adopted to bring about the required relative differences in taxes?

The most obvious and substantive differences between tax units that result in differences in the fraction of the unit's total economic power available for discretionary use are differences in marital status and differences in the numbers of dependants. In particular, we believe that the system should distinguish between tax units with the following characteristics:

1. Unattached individuals.

2. Married couples without dependent children.

3. Married couples with different numbers of dependent children.

We believe that, in general, a married couple has a smaller fraction of its total economic power available for discretionary use than an unattached individual with the same total economic power. The popular saying notwithstanding, two cannot live as cheaply as one. Therefore, the tax system should allocate a smaller tax to a married couple than to a bachelor with the same income. We also believe that in general when two people with the same income marry, the total tax on the couple should be greater than the sum of the taxes they paid when single. This increase is necessary to reflect the fact that there are some economies to be realized through living together. The basic relationships we accept are illustrated in Table 7-2. 4/

It is our view that an unmarried man with an income of $10,000 should pay taxes that are higher than those paid by a couple with the same income. This reflects our belief that the bachelor has a larger part of his income to spend as he sees fit than has a married couple with the same income. However, should two people, each with an income of $5,000, marry and continue to receive the same incomes, the tax levied on the couple, while less than the tax on an unattached individual with an income of $10,000,

should be greater than the sum of the taxes they paid when single. The higher tax on the couple reflects our belief that because of the economies of living together, a larger fraction of the aggregate income of the couple is available for discretionary use than the fractions that applied to their separate incomes before marriage.

TABLE 7-2

ILLUSTRATION OF THE EFFECT OF MARRIAGE ON THE FRACTION OF INCOME AVAILABLE FOR DISCRETIONARY USE

	Single Individuals		Married Couples	
Income Base	$10,000	$20,000	$20,000	$40,000
Assumed Fraction of Income Available for Discretionary Use a/	0.391	0.501	0.397	0.554
Measure of Discretionary Economic Power	$3,910	$10,030	$7,954	$22,154
Assumed Rate of Tax on Discretionary Income	50%	50%	50%	50%
Tax Liability	$1,955	$5,015	$3,977	$11,077
Average Rate of Tax on Income Base	19.5%	25.0%	19.8%	27.7%

a/ These average rates are consistent with the rate schedules recommended in Chapter 11.

Some figures may not be precise due to rounding.

It is also our belief that the relative differences in the taxes imposed on single individuals and couples should change with income. At the bottom of the income scale there are often diseconomies to marriage. Unmarried individuals with low incomes can, for instance, share living accommodation with more than one other person. On marriage, separate accommodation for the couple is generally required, as are expenses associated with the establishment of a household. When the incomes of the individuals are low,

these accommodations and household establishment expenses are probably greater than the savings possible on other living expenses. Consequently, we believe that there should be a lower tax for low income individuals, upon marriage, so that the total tax on the couple would in no case be greater than the sum of the taxes on the separate individuals.

At the very top of the income scale, marital status has relatively little effect on discretionary economic power. When two wealthy individuals marry, their total tax should be greater than the sum of the taxes they paid as single individuals to take into account the economies of living together, but these economies are small when compared to their income. The increase in tax upon marriage for such people should consequently be relatively smaller than for individuals with less income who marry. These more complex relationships are considered in greater detail in Chapter 11.

To achieve the desired relationship between the taxes levied on the incomes of unattached individuals and married couples, we advocate the adoption of two distinct rate schedules; one for each type of tax unit. We reject the use of one schedule and the adoption of a fixed exemption or tax credit to differentiate the taxes levied on the two kinds of units. To use one schedule for both kinds of units and a fixed exemption for the couple would be tantamount to the acceptance of the assumption that the extra non-discretionary expenses of a couple not only increase with income but increase at the same rate as the marginal rates of tax increase with income. This we cannot accept. We believe that when the level of income is substantial, the fraction of additional income available for discretionary use is the same for the couple as for the unattached individual. Adoption of an exemption would give an unwarranted tax reduction to upper income couples and would not be sufficiently generous for low income couples.

The adoption of a credit to differentiate the tax on couples and unattached individuals would pose exactly the opposite problem. This would be tantamount to the acceptance of the assumption that the extra non-

discretionary expenses of the couple do not increase with income. If a substantial credit were provided, this would be too generous for low income couples and not sufficiently generous for middle and upper income couples.

By adopting two rate schedules a middle ground can be taken, and the relationship between the taxes on unattached individuals and couples can be more precisely adjusted to achieve an equitable result.

We believe that couples with dependent children have a smaller fraction of their total income available for discretionary use than childless couples. The more children the couple have, the smaller the fraction of income available for discretionary use. The first child is, however, more expensive than subsequent children because the living accommodation adequate for a childless couple is often unsuitable for children. However, the same clothing and equipment can often be used for subsequent children.

The actual expenses of parents which arise from the existence of children probably increase with income, but not as rapidly as the marginal rates of tax increase with income. The use of exemptions for children is therefore an inappropriate technique for differentiating the tax burdens between couples with and without children. The adoption of a system of credits probably errs in the other direction. The most refined technique would be to adopt separate rate schedules for tax units with one child, two children, three children, and so on. But additional rate schedules to differentiate couples with different numbers of dependent children would introduce complexities for taxpayers that would not be justified by the relatively small amounts involved. Credits against tax are simpler and the inherent bias of fixed credits would be in favour of low income families as we think it should be. To recognize the greater expenses associated with the first child, a larger credit should be provided for the first child than for additional children.

The differences in the fraction of income which we assume to be available for discretionary use, for couples without children and couples with one child, are illustrated in Table 7-3.

TABLE 7-3

RELATIVE REDUCTION IN AVERAGE TAX RATES TO REFLECT THE REDUCED FRACTION OF INCOME AVAILABLE FOR DISCRETIONARY USE FOR COUPLES WITH DIFFERENT INCOMES, WITH OR WITHOUT CHILDREN

	Low Income Couple		High Income Couple	
	Childless	With One Child	Childless	With One Child
Income Base	$5,000	$5,000	$30,000	$30,000
Assumed Fraction of Income Available for Discretionary Use	0.183	0.143	0.485	0.478
Measure of Discretionary Economic Power	$ 914	$ 714	$14,554	$14,354
Assumed Rate of Tax on Discretionary Income	50%	50%	50%	50%
Tax Liability	$ 457	$ 357	$ 7,277	$ 7,177
Average Rate of Tax on Income Base a/	9.1%	7.1%	24.2%	24.0%

a/ These average rates are consistent with the rate schedules recommended in Chapter 11.

Some figures may not be precise due to rounding.

Recognition of Differences in Specific
Non-Discretionary Expenses

The data given in Table 7-3 reflect the assumed general relationship between income and discretionary income for tax units with different family responsibilities. However, some specific non-discretionary personal expenses are made by some tax units but not by others. The allocation of taxes in accordance with ability to pay requires that tax units with these expenses should pay lower taxes than units with the same family responsibilities and the same income who do not have the same special expenses. At least some part of the following expenses are, we believe, non-discretionary:

1. Extraordinary medical expenses.

2. Gifts to close relatives to provide them with support.

3. The special expenses of working mothers with young children.

It is implied by our ability-to-pay principles that these specific expenses should be taken into account by providing a credit against tax equal to the top marginal rate multiplied by the amount of the expense. This is equivalent to reducing the discretionary income of the tax unit by the amount of the specific non-discretionary expenditures. This can best be explained by a simple example.

Suppose that a taxpayer with an income of $6,250 has a specific non-discretionary expense of $750. Suppose further that the rates of tax are as provided in the hypothetical schedule given in Table 7-1. As can be seen from the table, it has been assumed in constructing the schedule that a taxpayer with an income of $6,250 has $2,520 in discretionary income. With a rate of tax on discretionary income of 50 per cent, the tax on this income would be $1,260. However, if the taxpayer has a specific non-

discretionary expense of $750, his discretionary income is $1,770 rather than $2,520. His tax should therefore be 50 per cent of $1,770, or $885, rather than $1,260. By providing a credit equal to 50 per cent of the $750 specific non-discretionary expense against the $1,260 tax liability on an income of $6,250, the net liability would be reduced to $885 as it should be.

The "ideal" approach poses the problem of estimating the non-discretionary component of actual expenses. What part of the money given to a close relative is "support", and what part is a gift? To what extent does a baby-sitter hired by a working mother perform the services of a maid? These impossible valuation problems can be avoided or reduced, while recognizing these non-discretionary expenses, by providing fixed, arbitrary credits unrelated to the amounts actually expended or by placing limits on the amounts of the credits.

The possibility of the introduction of some form of universal and compulsory medicare introduces special considerations with respect to medical expenses as discussed in Chapter 12.

Later in the Report we recommend special credits for the costs of post-secondary education, deductions for charitable donations, and exemption for certain gifts received. These are recommended as incentives in the first two cases and largely as an administrative convenience in the latter case.

BASIC EXEMPTIONS

In arriving at the income levels at which tax liabilities should begin, we have taken into account, as far as possible, the redistributional effects of other taxes, government transfer payments, and government expenditures.

We have not tried to exclude from personal income tax an absolute amount that purports to be the income necessary to maintain a minimum standard of living. The idea that income taxes should not reduce income below "subsistence" is laudable in its intention but, we believe, misconceived. Subsistence has no absolute meaning. It is the relative positions of individuals and families that are important. Furthermore, neither exemptions from tax nor credits against tax can ensure that every Canadian has a minimum income. This objective can only be achieved through increased government transfer payments including, for example, refundable credits against taxes. The income tax system as such cannot be used to help people without income—those who most need the help.

We are convinced, however, that the first dollars of income should not be subject to tax. Clearly the fraction of income available for discretionary use is extraordinarily small for a family with an income of, say, $2,000. Moreover, such a family bears sales and property taxes that are disproportionately large relative to its ability to pay. To reflect our belief that those with low incomes have little if any discretionary power, and to compensate for these other taxes, we recommend two zero brackets: one for unattached individuals and one for family tax units. These zero rate brackets are equivalent to the adoption of exemptions equal to the zero brackets, or schedules of rates that tax income in the first bracket but allow credits that just offset the tax on the first bracket.

It is sometimes argued that exemptions should reflect regional differences in living costs. There is no doubt that in some remote areas of Canada living costs are extremely high because of high transportation costs. In order to attract workers to these areas employers

have to pay high wages and salaries. To exempt a higher proportion of the incomes of people living in these remote areas would be, in effect, to subsidize their employers. We think it would be most unwise to hide the real costs of the development of remote areas through a personal income tax exemption. To introduce regional differences into the tax system would, moreover, produce an endless factious debate. If it is government policy to accelerate such development, we would recommend that subsidies be granted openly and explicitly.

ECONOMIC POWER

In order to allocate taxes in accordance with the equity principles we espouse, we must specify a tax base that would estimate consistently the economic power of each individual and family relative to others. There is, of course, a variety of methods by which economic power, the ability to command goods and services for personal use, can be estimated. Some are conceptually pure but impossible to administer; others are readily administered but depart significantly from the spirit of the concept. The problem is to specify a tax base that maintains the integrity of the concept without creating insuperable administrative difficulties.

At a point in time, a person's economic power can be measured by the market value of his net assets 5/. The money he holds and the money he could obtain by exchanging his other assets for money, determines his personal command over goods and services (given prevailing prices).

But this is not a useful measure in our context. If the tax base of each taxable unit were measured by the market value of the unit's assets,

excluding human capital, 6/ on a given date each year, the units that derived all of their income from personal effort could easily arrange their affairs so that they received and spent large sums between these dates but yet had no marketable assets on these dates. Such a tax-planning prodigal who received employment income could arrange to have little if any economic power on the crucial date if such a measure were used, despite the fact that he had exercised economic power whenever he consumed goods and services during the year. The financial or physical assets of the saver would, however, be taxed year after year.

These problems can be avoided by measuring all changes in economic power over a period of time rather than economic power at a particular point in time. The choice of any time period is inherently arbitrary. The conventional choice is, of course, the calendar year. Using this unit of time, a tax unit's economic power can be measured as the sum of the following: 7/

1. The market value of the goods and services used up by the tax unit during the year to satisfy its own wants (consumption).

2. The market value of the goods or services given to other tax units during the year (gifts).

3. The change over the year in the market value of the total net assets held by the tax unit (current saving = change in net worth = change in wealth). This may be either a positive or a negative figure in any time period.

Given our definition of economic power there can be no doubt that item 1, consumption, should be included in the annual tax base. This measures the goods and services that the tax unit actually commanded over the year. The value of gifts made by the tax unit to other tax units, item 2, are included because they represent consumption goods and services the tax unit could have commanded

in the year had it chosen not to transfer this command to someone else. The making of a gift is a form of exercise of economic power. Inclusion of item 3, the change in the market value of the unit's net assets over the year, would result in taxing the change in the potential command over goods and services after taking into account the command actually exercised during the period.

By taxing in each year the actual consumption plus the change in potential consumption over the year, rather than the potential at some point of time during the year, the tax base given above avoids the valuation of human capital and avoids the repeated taxation of the same net assets year after year. This is not to deny that taxing this base involves taxing additions to assets and also taxing the returns that may later be earned by these assets. By taxing the change in net assets each year, from the beginning to the end of each person's life, the system would succeed in taxing all the tax unit's wealth once, but only once.

It is not suggested that this concept of the tax base should be written into the Canadian taxing statute. For a number of reasons that we discuss in Chapter 8, this concept must be reformulated and modified to arrive at an administratively feasible tax base. But if these practical problems are ignored for the moment, one of the main points we want to make can be seen. The proposed tax base must of necessity take into account all of a person's net gains over the year. All gains, after meeting the expenses necessary to generate them, must be reflected in the base because all of them must be disposed of in one of the three ways we have specified in the tax base. The distinction between wages, interest, dividends, business income, gains on shares, bequests, sweepstake winnings, and so on, all would disappear. Because it encompasses more than the present tax base, we have called our new concept the "comprehensive tax base".

We believe that the comprehensive tax base would measure the relative economic power of individuals and families on a consistent basis. Its very

consistency would in fact produce a radical change from the present income tax base. Whether one wishes to consider it as a great broadening of the concept of income or as a fundamentally different tax base is of little consequence. Certainly we do not think that anything is to be achieved in this context by a debate about the meaning of words. It ultimately does not matter whether capital gains, gifts and bequests are or are not called "income". What does matter is that these things increase the economic power of those who are fortunate enough to receive them, and therefore should be taxed like wages, salaries, rent, dividends, interest and so on. If economic power is increased it does not matter in principle whether it was earned or unearned, from domestic or foreign sources, in money or in kind, anticipated or unanticipated, intended or inadvertent, recurrent or non-recurrent, realized or unrealized. When we use the term "income" in the context of the tax system we are proposing, we mean the comprehensive tax base as we have just described it.

Our acceptance of the comprehensive tax base is an implicit rejection of the allocation of taxes in accordance with either wealth or consumption. We want to make our reasons for rejecting them explicit.

Consumption Expenditure as a Tax Base

To tax consumption expenditure rather than the comprehensive tax base would in effect exempt current saving, that is, additions to wealth, from tax. If adequate aggregate demand were maintained, this exemption probably would increase, although not dramatically, the rate of domestic saving. This in turn would increase the rate of capital formation or reduce Canada's reliance on foreign saving. In either case the future output of goods and services available to Canadians would be increased. As we stressed in Chapter 4, however, this improvement in the future economic welfare of Canadians would not be costless; until Canada realized the potential growth rate that could be achieved virtually without cost, it would seem foolish to

recommend that domestic saving be increased in this way. Even if a higher saving rate were required to meet a target growth rate set by government, there are alternative methods by which domestic saving could be increased more equitably. These are discussed in Chapter 4. We can see no reason on equity grounds to discriminate between the dollar destined for consumption and the dollar destined for the acquisition of property rights and interests.

For the vast majority of people, the choice between the comprehensive tax base and a consumption expenditure tax base would probably affect little more than the timing of their taxes. Most of us come into the world with nothing and leave it in much the same state; we neither make nor receive significant gifts; we neither inherit nor leave large estates; over our lives our consumption expenditures approximately equal our income. A more favourable tax treatment of saving would be unlikely to induce most of us to accumulate wealth so that we could give or bequeath it to others. The taxation of consumption rather than income, broadly defined, would therefore serve but to shift the tax burden from middle age, when saving usually is at its peak, to youth and old age when funds are usually being borrowed or assets drawn down. We are convinced that there is no justification for a tax change that would produce this result.

There are, of course, a few people who give or bequeath substantial wealth which has been accumulated out of their lifetime income. The move from income to consumption taxes would reduce their tax burdens relative to those of others. For this small group such a change would certainly tend to encourage saving, except for those who are saving toward a target amount. But we are doubtful whether it would make a significant difference in the number of people who want to accumulate wealth for these purposes or in the amount of wealth accumulated. In any event, we do not believe that the person who is putting funds aside for gifts or bequests has a smaller taxable capacity than another person in the same circumstances and with the same income who does not. We therefore reject consumption expenditure as a tax base.

Wealth as a Tax Base

We have suggested earlier in this chapter one of the reasons why we reject wealth as a tax base. If it were practical to define wealth to include human assets, and if human assets were traded in the market on the same basis as physical and financial assets, we acknowledge that wealth would be a good indication of economic power at a point in time. But in a free society human assets are not treated like other assets. The problems of valuing such assets are great and they cannot be "liquidated" to satisfy a tax liability. Yet to ignore human assets would grossly understate the ability to pay of those who earn and immediately spend employment income.

Furthermore, even if human capital could be included with other assets, to tax both additions to assets (saving), and then to tax repeatedly the stock of assets, while failing to tax consumption, would seriously discriminate against one disposition of the income generated by assets relative to another. For example, suppose there are two men each of whom has a net worth (including human capital) of $200,000. Suppose that no taxes have been paid by either in the past. If the government had to raise $10,000 from them now, it would seem reasonable that each should pay an equal tax of $5,000. Let us suppose that over the following year each earns $10,000 in cash, but one consumes the whole $10,000, while the other spends $5,000 on consumption and saves $5,000. The larger spender ends the year with a net worth of $195,000; the saver ends the year with a net worth of $200,000. If wealth were used as the index of ability to pay the spender would have less ability to pay than the saver. But we can hardly ignore the fact that both received the same increase in economic power during the year. On equity grounds we cannot justify exempting the dollar destined for consumption any more than we can justify exempting the dollar destined for saving.

While we do not think it would be appropriate to recommend exempting savings from tax by placing greater weight on consumption taxes relative to income taxes, we are equally opposed to taxing saving more heavily by imposing

taxes on wealth as such. Such a wealth tax would, we believe, not only be inequitable but would also tend to reduce the rate of domestic saving and thus reduce the rate of capital formation or, alternatively, increase Canada's reliance on foreign saving.

Imposing taxes on the comprehensive tax base each year, as we propose, would tax all additions to wealth. Over time, all of a man's wealth would be taxed, but only once. This is substantially more stringent than the present system under which increases in economic power from some sources are not taxed at all.

There are, we acknowledge, some legitimate grounds that can be advanced for taxing wealth as such. First, by levying a low rate of tax on all net worth at regular intervals, the owners of property would be put under pressure to hold assets that yield a high cash return. If administratively feasible, it also would tend to compensate for the exclusion from the comprehensive tax base of imputed income derived from owner-used property. Secondly, a net worth tax could be imposed to increase the redistributive effect of the tax system.

It may be thought by some that a top personal rate of 50 per cent would not result in a sufficiently progressive tax system despite the great broadening of the base that we recommend. If still greater progressiveness in the tax system were desired, a net worth tax at a low rate, say, 2 per cent, levied on net assets over $1 million every few years would probably be administratively feasible and would increase the redistribution effects of the tax system while retaining the 50 per cent top personal rate 8/.

We do not recommend such a net worth tax because we do not want to penalize saving and because we are convinced that the comprehensive tax base with the rate structure we recommend would achieve an adequate degree of progressiveness in the tax system. On the other hand, if more progression

were required, we would prefer to see the imposition of such a net worth tax rather than the acceptance of a top marginal personal rate that was much above 50 per cent.

Consumption and Wealth Taxes as Methods of Collection

Acceptance of the comprehensive tax base as the best indicator of economic power does not mean rejection of all taxes on wealth and on consumption. Property taxes and retail sales taxes, to name but two important variants of wealth and consumption taxes, have sufficiently useful attributes to justify their continued existence. In particular, we think it is important that each of Canada's three levels of government have a tax source over which it has primary control, although we do not mean to suggest that each level of government should rely exclusively on one type of tax. The present arrangement under which the municipalities rely extensively on property taxes and the provinces rely extensively on retail sales taxes has a great deal of merit because it gives each level of government a degree of fiscal autonomy and hence fiscal responsibility. While we think it important that there should be more joint decision making between the federal and provincial governments with respect to sales taxes and income taxes, this is not inconsistent with the idea that each level should administer one major tax.

From the point of view of equity, however, we believe that wealth and consumption taxes, other than those imposed on a fee-for-service basis, should be methods of collecting taxes rather than independent levies. Ideally, therefore, taxpayers should be given full credit for some portion of consumption and wealth taxes against their tax liabilities determined by a progressive rate structure applied to the comprehensive tax base. These credits for consumption and wealth taxes should be refundable to the extent that they exceed income tax liabilities. The credits would have to be arbitrary in amount for two reasons. First, it would be impossible to measure the actual

consumption taxes paid by a particular taxpayer or the proportion of property taxes levied on a fee-for-service basis, or the property tax component of residential rents. Second, the federal government should not be put in the position of having to raise its taxes every time a province or municipality raises its own, thereby increasing the federal credit required.

We have decided not to recommend this arbitrary refundable credit for sales and property taxes. To do so would be to recommend, in effect, the adoption of a negative income tax. As we have suggested earlier, we strongly recommend that the transfer system as a whole be reviewed. The present system is cumbersome and has important gaps and there is some overlapping. The advantages and disadvantages of a negative income tax can only be appraised in this wider context.

It must be recognized that the full integration of all of these taxes would require a dramatic increase in marginal rates. These higher rates might have substantial disincentive effects that would have to be weighed against the improvement in equity that would be attained.

There is, however, a middle ground between complete integration and no integration of these taxes. By gradually reducing the relative weight of consumption and property taxes in the system, by reducing or compensating for the regressive features of sales taxes, and by reducing the weight of personal income taxes on the lower income brackets, Canada can move closer to the objective of allocating taxes according to ability to pay. We are recommending that a start should be made on all of these fronts. Subsequently, more could be done by increasing the width of the individual and family unit zero rate brackets, or by adopting a system of refundable tax credits in lieu of these zero brackets so that those in the lowest income brackets would obtain a refund (admittedly arbitrary in amount) of sales and property taxes.

We want to emphasize that either course of action would be consistent with our basic approach. Certainly implementation of the second alternative would represent the natural evolution of the tax system we are proposing.

The Income of Organizations
as a Tax Base

It is sometimes argued that legal entities and institutions such as corporations and trusts, which we will call intermediaries, have tax-paying capacity. With our concept of ability to pay this cannot be so. For us, tax-paying capacity arises from discretionary economic power, and intermediaries cannot have discretionary economic power—the residual power to command goods and services for personal use. Consumption is a strictly human trait. But the question is not simply definitional; all the assets and net receipts of intermediaries are ultimately held by, or accrue to the benefit of, natural persons. What happens to intermediaries necessarily affects the interests of natural persons whatever the intention. Here too, taxing intermediaries is a convenient collection technique but the ultimate burden is on people. Because there are good and sufficient reasons why income taxes on resident organizations cannot be abandoned (as discussed in Chapter 19), we are convinced that the taxes levied on the incomes of resident organizations and resident individuals should be fully integrated through the provision of a refundable tax credit for the tax paid by corporations and other intermediary organizations against personal income tax liabilities.

Our principles concerning ability to pay relate primarily to residents of Canada and our recommendations reflect this. It is not ordinarily possible or appropriate to measure the tax liabilities of non-residents with respect to Canadian source income by reference to this ability to pay.

Accordingly, for a variety of reasons outlined in Chapter 26, we recommend that, in general, income derived from Canadian sources by non-residents should be subject to withholding taxes at arbitrary rates and that non-residents should not receive refundable tax credits for taxes paid by corporations or other organizations in which they hold interest. However, we believe that in some specified circumstances it is feasible and appropriate

to give non-residents the opportunity to have their tax liabilities determined by reference to their ability to pay. We recommend in Chapter 26 that in these circumstances they be given the option to file tax returns as Canadian residents.

CONCLUSIONS AND RECOMMENDATIONS

1. Government expenditures should be financed through taxes allocated according to ability to pay, except in those instances where the direct benefits from a good or service provided by government can be readily allocated to particular individuals in a way that would be generally accepted as fair and where any indirect benefits to others are minor.

DEFINITION OF ABILITY TO PAY

2. The allocation of taxes in accordance with ability to pay requires the proportionate taxation of the discretionary economic power of families and unattached individuals. Discretionary economic power is defined as:

    a) the total power of the unit to command goods and services for personal use; less

    b) the power necessarily exercised to maintain the appropriate standard of living of the unit relative to other units.

3. The fraction of a tax unit's total economic power which is available for discretionary use, relative to the corresponding fractions for other units, is, we believe, determined by relative differences in income, family responsibilities and certain specific non-discretionary expenses.

RECOGNITION OF DIFFERENCES IN INCOME

4. Up to a limit, the greater the total income (as measured by the comprehensive tax base) of the unit, the higher is the fraction of that

income which is available for discretionary use. Beyond that limit, all of the unit's income is available for discretionary use. Below that limit, equal percentage differences in income are associated with equal differences in the fraction of additional income available for discretionary use.

5. Taxes can be allocated among units with the same family responsibilities and the same special non-discretionary expenses in proportion to their respective abilities to pay by imposing on a base that measures the total economic power of each unit a schedule of progressive marginal rates of tax where:

   a) the top marginal rate of tax is reached at $100,000;

   b) brackets encompass equal percentage differences in income;

   c) marginal rates rise by equal amounts from bracket to bracket; and

   d) the top marginal rate is equal to the rate of tax on discretionary economic power and is determined by revenue requirements.

6. Combined with a transfer-expenditure system that provided greater benefits for those with the lowest incomes, the adoption of a tax system with the characteristics we have just described would redistribute goods and services in favour of those at the bottom of the income scale, and would ensure that the costs were allocated in proportion to ability to pay.

RECOGNITION OF DIFFERENCES IN FAMILY RESPONSIBILITIES

7. Both families and unattached individuals should be recognized as basic tax units. The incomes of the members of families should be aggregated for tax purposes. Transfers between members of the same family should not be subject to tax; gifts from one tax unit to another should be brought into the tax base of the recipient unit but should not be deductible by the donor unit.

8. To reflect the heavier responsibilities of a married couple, the tax payable by such a couple should be less than the tax payable by an unattached individual with the same income.

9. To reflect the economies possible when two individuals with substantial incomes marry and live together, the tax on the couple should be greater than the tax on two single individuals each with half the income of the couple. To reflect the extra costs arising upon the marriage of two individuals with low incomes their total tax should be reduced.

10. The desired differences in treatment reflecting different abilities to pay can be achieved by the adoption of two rate schedules, one for families and one for unattached individuals.

11. Couples with dependent children have heavier responsibilities than childless couples, and the taxes allocated to the former should therefore be less than those allocated to the latter. This can be achieved by adopting fixed credits for dependent children, with a larger credit for the first child.

RECOGNITION OF DIFFERENCES IN SPECIFIC NON-DISCRETIONARY EXPENSES

12. Tax units that have extraordinary medical expenses, support close relatives, and have special expenses because the mother works should pay lower taxes than comparable units that do not have these specific expenses. To conform to our ability-to-pay principles the relief should be provided in the form of a tax credit equal to the assumed non-discretionary component of these expenditures times the top marginal rate of tax. There are, however, administrative problems in applying the "ideal" method.

BASIC EXEMPTIONS

13. Income in the first bracket should be free of tax, partially to compensate for sales and property taxes, for which credit is not given against income tax liabilities and partially because the first few

hundred dollars of income are not available for discretionary use. The width of this zero rate bracket should not purport to exempt a minimum subsistence income from tax nor should it vary with regional living costs.

THE COMPREHENSIVE TAX BASE

14. To avoid both understating the total economic power of those individuals whose major asset is human capital and the repeated taxation of the same physical and financial assets, we recommend that the tax base should include the change in each tax unit's economic power each year. This is defined to include:

a) the market value of the goods and services used up by the tax unit during the year to satisfy its own wants (consumption);

b) the market value of the goods or services given to other tax units during the year (gifts); and

c) the change over the year in the market value of the total net assets held by the tax unit (current savings = change in net worth = change in wealth).

We have called this the comprehensive tax base because it includes, in principle, all additions to economic power without regard to source, intention or form, and whether consumed or saved. In Chapter 8 this concept is reformulated and modified to arrive at an administratively feasible tax base.

WEALTH AND CONSUMPTION AS TAX BASES

15. Independent taxes on consumption and on wealth are inconsistent with our ability-to-pay principles except when applied on a fee-for-service basis. They should therefore either be abandoned or integrated with personal income taxes. Abandoning these taxes would be undesirable because each level of government should have a revenue source for which

it is primarily responsible. Full integration would require dramatic increases in marginal rates that could have adverse economic effects. However, partial integration of sales and wealth taxes with personal income taxes could be achieved by providing a refundable arbitrary credit against personal income taxes. To recommend the adoption of a refundable tax credit for these taxes would be to recommend the adoption of a negative income tax. The advantages of such a system should be carefully considered in the context of a review of the transfer system as a whole. We have not extended our inquiry into this area and, therefore, we are not prepared to propose the adoption of negative income taxes.

THE INCOME OF ORGANIZATIONS AS A TAX BASE

16. Intermediaries such as corporations and trusts should not be regarded as entities with tax-paying capacity. It should be recognized that the taxes they pay are borne by people, and accordingly there should be integration of the taxes on resident individuals and families with the taxes imposed on intermediaries. This can be achieved by providing a refundable tax credit to resident shareholders for the income taxes collected from organizations.

17. It is not feasible to measure the ability to pay of non-residents except in certain specified circumstances. Accordingly, in general income derived from Canada by non-residents should be subject to withholding taxes at arbitrary rates and non-residents should not receive refundable tax credits for the income taxes paid by organizations.

REFERENCES

1/ It is sometimes argued that when taxes are allocated among individuals in proportion to, or in increasing proportion to, income this is the best crude apportionment of taxes according to overall benefits received. If this theory is correct, the sharp distinction between benefit and ability-to-pay taxation disappears.

2/ This limit is obviously arbitrary.

3/ This is equivalent to the statement that marginal rates of tax plotted against the logarithm of income constitute a straight line.

4/ For an extensive survey of the tax treatment of the family in many other countries, and a discussion of the propositions in the text, see O. Oldman and R. Temple, "Comparative Analysis of the Taxation of Married Persons", Stanford Law Review, Vol. 12, 1960, pp. 585-605.

5/ Also called net worth or wealth.

6/ For all practical purposes it is impossible to measure the market value of each man's human capital, that is, the present value of his future net earnings arising from his strength, skill and knowledge.

7/ This is a modification of the definition of income advocated by H. C. Simon, Personal Income Taxation, Chicago; University of Chicago Press, 1958, p. 41, following the definition of R. M. Haig.

8/ Retaining the top personal rate of 50 per cent is highly desirable because only if the top personal rate is approximately equal to or less than the tax rate levied on corporate income is the full integration of corporate and personal income taxes feasible. We could not countenance an increase in the rate of tax levied on corporations, both because of its depressing effects on domestic investment and because of the international ramifications.

CHAPTER 8

BASIC FEATURES OF THE COMPREHENSIVE TAX BASE

The present chapter serves as an introduction to the application of the comprehensive tax base in a working income tax system. Its main purpose is to reformulate the comprehensive tax base to take account of some of the limitations imposed by practical considerations, and to examine the implications of the comprehensive tax base in several broad areas where decisions are crucial to the later application of the concept. The general conclusions stated in this chapter are developed in more detail in subsequent chapters.

THE COMPREHENSIVE TAX BASE REFORMULATED

The comprehensive tax base has been defined as the sum of the market value of goods and services consumed or given away in the taxation year by the tax unit, plus the annual change in the market value of the assets held by the unit. It would be futile to write such a definition into a taxing statute because it does not provide sufficient delineation, either to taxpayers or tax administrators, to make compliance and enforcement possible. In particular, it would be impossible to measure directly the value of the goods and services consumed by each Canadian individual or family each year. Similarly, an annual valuation of all assets is impractical.

Fortunately, the comprehensive tax base can be restated in such a way that most of the compliance and enforcement problems can be substantially solved without a major departure from the basic concept. By taxing all the net gains, appropriately defined, of each tax unit on an annual basis, it is possible to achieve the same result as taxing each unit's "consumption plus gifts plus change in net worth", while avoiding the problem of measuring the value of the unit's annual consumption.

The definition of "net gains" is, of course, of crucial importance. The following reformulation of the comprehensive tax base in terms of net

gains provides a useful starting point, although we discuss later how this formulation also requires extensive modification, essentially for administration reasons:

1. The tax base of each unit would include the annual net gains less net losses, from:
   a) the provision of personal services;
   b) the disposal of tangible or intangible property;
   c) the receipt of gifts or legacies from other tax units;
   d) the receipt of windfalls;
   e) the ownership of tangible or intangible property;
   f) any combination of these "sources".

2. Gains can take one or all of the following forms:
   a) the receipt of cash;
   b) the acquisition of rights to, or interests in, property;
   c) the receipts of benefits in kind as a quid pro quo;
   d) a change in the value of a right to, or an interest in, property;
   e) the personal use and enjoyment of property that could have been rented to others—that is, gains forgone.

3. Cash, or rights to, or interests in, property disposed of by the unit in the expectation of generating or acquiring a net gain should be deducted from the gross gain to determine the net gain or loss.

4. Net gains and losses should be determined on the basis of fair market value.

5. Net gains that could be realized by the tax unit, but are not so realized because the property in question is transferred to another unit as a gift or for an inadequate consideration, should be included in the tax base of the donor, and the amount

by which the consideration is inadequate should be included in the tax base of the donee.

Some of the salient features of the "net gains" formulation of the comprehensive tax base, as we have just defined it, should be emphasized:

1. The tax base would include gifts and bequests received from other tax units. This is appropriate because these amounts represent an acquisition of economic power. In view of this concept, the estate taxes and gift taxes would be withdrawn.

2. The tax base would include imputed income, that is, the gains realized when a person uses or consumes his own personal services or his own property. In most circumstances, however, as we indicate later, the valuation and administrative problems involved in including such amounts in income are insuperable.

3. The money value of gains in kind would be included on the same basis as money gains. This will be discussed later in this chapter. Here, too, there are valuation problems.

4. When the market value of rights to, or interests in, property changes, the tax unit has a net gain or loss, according to our formulation of the comprehensive tax base. This means, in effect, that gains and losses would be included in the base on an accrued rather than on a realized basis. Once again we are confronted with serious valuation problems. What in our opinion should be brought into the base is clear; what <u>can</u> be brought into the base as a practical matter is discussed later in this chapter.

5. <u>All</u> of the expenses reasonably incurred to earn gains, other than personal living expenses, would be allowed as deductions from such gains. Distinctions between the forms of taxable gains, or considerations of whether a gain was actually made, would not be

relevant in determining whether the expenses were deductible. The major question would be when, not whether, the expenses incurred in the expectation of obtaining a net gain would be deducted. Our basic approach to this question of the timing of business deductions is discussed further in Chapter 9 and in Chapter 22.

6. No personal consumption expenditure would be deducted. This follows from the basic concept we have already enunciated, which involves taxing all changes in economic power defined as "consumption plus gifts plus change in net worth". The need to prevent the deduction of personal consumption expenditure has some far-reaching consequences. Three of the more important can be briefly described:

a) A tax unit which makes gains cannot be allowed to deduct from those gains general living expenses. The problem of separating the expenses incurred to earn income from the general expenses of living is discussed in Chapter 9.

b) The net losses incurred in operating a "business" where there is no expectation of earning a net gain from the business, even in the long run, should not be deductible from income derived from other sources. The presumption must be that the owner is obtaining personal satisfaction from operating the business and that the losses of the business are therefore disguised personal living expenses. This problem will be discussed in Chapter 9 and Chapter 22.

c) Gifts are not expenses incurred in the expectation of generating net gains and should not be deducted from gross gains or receipts.

SOME GENERAL IMPLICATIONS

In the remainder of this chapter we consider the full implications of the comprehensive tax base for several stubborn general questions of income definition and taxation. The general areas we consider are: depreciation of human capital; benefits in kind; transactions not at arm's length; imputed income; realization of gains; and intermediaries.

Depreciation of Human Capital

The health, strength, knowledge and skills of individuals can all be included under the designation of human capital. It has been suggested that human capital should be treated like other productive assets for tax purposes. Under such an approach the returns from employment would be reduced by the expenses of maintaining the worker, and depreciation would be allowed on the worker's health, strength and knowledge in order to arrive at the taxable net return. This approach is, we believe, inappropriate for a tax system. The whole purpose of depreciation is to allow the recovery of costs incurred in order to determine the net return. While no one would deny that raising a human being involves costs, the costs usually are borne by the parents and society as a whole, and would not have been borne by the individual claiming the deduction (as they are when physical assets are acquired).

Furthermore, there would be insuperable administrative problems, because a worker's expenditures on his own maintenance could not be separated from those he incurred for his personal satisfaction.

Benefits in Kind

In our reformulation of the comprehensive tax base we specify that benefits in kind must be included in the tax base. Benefits that "save the pocket" obviously increase the economic power of the recipient, just as do cash receipts that go into the pocket. One of the areas of inequity in the

present system is the fact that many such benefits, which are untaxed or only partially taxed, are available to some taxpayers and not to others. If benefits in kind are not taxed, the buyer and seller in a transaction can arrange that the seller be remunerated with tax-free benefits in kind with the tax saving divided between them.

Benefits in kind take many forms, ranging from substantial items like the use of a car or a house, life insurance, retirement benefits, provision of board and lodging, discounts on merchandise, and interest-free loans, to trivial items like a free Christmas turkey. Most such benefits arise from employment or from the operation of a business. The gross gain from any transaction can take the form of goods, services or the use of property.

The failure to tax benefits in kind gives tax units that can obtain their remuneration in this form an advantage over others. Furthermore, if some forms of benefits in kind are not taxed, it is equivalent to subsidizing the goods and services that are available free of tax, relative to all other consumer goods and services that can only be purchased from tax-paid income. The subsidized goods and services will be substituted for other goods and services.

When benefits in kind have an established market value, their taxation is a relatively simple matter. The form of the benefit is frequently the result of a specific deal between the buyer and seller and is not shared with others. Frequently, however, these conditions do not exist.

Some of the relevant circumstances cannot be ascertained objectively because it will always be in the interest of the parties to these arrangements to understate the benefits for tax reasons. Because the possibilities of abuse are so great, we are firmly convinced that a very hard line must be taken toward the taxation of benefits in kind. This involves the adoption of several rules:

1. Ordinarily the recipient of benefits in kind should bring into his tax base what the benefits would cost if purchased in the market.

2. The tastes and preferences of recipients of benefits in kind should be ignored for tax purposes. It must be assumed that the recipient had a choice between the benefit itself and the receipt of a cash payment that would have enabled its purchase in the market. To the extent that the benefit is worth less to the recipient than its market cost, he should arrange to receive his remuneration in a different form or obtain additional remuneration to compensate for the tax liability implicit in the receipt of the benefit in kind.

3. Benefits in kind can be received in the course of performing services for a net gain, for example, the food and shelter consumed while out of town on a legitimate business trip. The objective here must be to bring into the individual's tax base:
   a) the extra cost of providing food and shelter that is of better quality or in greater quantity than would usually be purchased by the individual from tax-paid income;
   b) any reduction in personal expenditure that is made possible by being away from home;
   c) any expense incurred to satisfy the individual rather than to produce income.

Because the tax administration cannot possibly determine the style or preferences of each individual, and therefore cannot determine in an objective fashion the value of these benefits, arbitrary standards should be adopted and the value of benefits in kind in excess of these standards should be brought into the tax base of the recipient.

4. Where a common facility provides benefits in kind to a number of individuals simultaneously, the benefit should be apportioned among them, failing which, a special tax should be imposed on the party providing the benefit.

While we recognize that the application of these rules would not be easy or costless, we are convinced that such benefits have thus far not been dealt with adequately. The result has been a lessening in taxpayer morale and loss of faith in the integrity of the tax system. The revenue loss may not be great, but to those who are able to obtain them, tax-free benefits may be very significant. We feel that the law should be made more explicit and that greater administrative effort should be devoted to enforcing the law dealing with benefits in kind. We also recommend later more stringent reporting requirements in this connection for businesses and organizations.

Transactions Not at Arm's Length

When the two parties to a transaction do not have conflicting interests, the prices at which goods and services are bought and sold, or the terms on which they are bartered, may not reflect market values. The terms may be such that one party is, in effect, making a gift to the other. The net gain of one of the parties will be understated if the transaction is accepted at face value. This can occur when, for example, a proprietor of a business employs his son-in-law at a salary that will allow the proprietor's married daughter to maintain her previous standard of living, rather than at the market value of his son-in-law's services. The net income of the proprietor is understated if the gift to his daughter, by way of his son-in-law, is deducted as an expense of the business.

There can be no completely satisfactory solution to the problem of transactions not at arm's length. Our recommendation that the income of husband and wife and dependent children be aggregated for tax purposes will only remove one of the problem areas. In our opinion it is therefore necessary

to maintain the test of "reasonableness" for the deduction of business expenses to prevent an indirect gift from being deductible to the donor. Moreover, it is important that the tax authorities exercise vigilance to prevent the understatement of net gains arising from transactions that do not take place at fair market value.

Imputed Income

When an individual who owns productive assets, or who supplies production services, uses them directly to produce goods and services that he consumes himself, it is extremely difficult to value the net gain. The self-sufficient farmer is the obvious example of a man who, in effect, barters his own time and the use of his own capital for the food he eats. But there are a multitude of less obvious cases. The man who occupies a home that he owns, the carpenter who builds his own furniture, and the handyman who repairs the leaky faucet in his own home all receive a net gain in the sense that had each sold his services or rented his property in the market, the gross gain would be taxable, and few, if any, deductible expenses would be incurred in generating the gain. On the other hand, the expenses of having someone else perform the service or of renting the property from others are general living expenses which would not be deductible.

Imputed gains are extremely difficult to cope with under an income tax system. Indeed, in a country where self-sufficiency was generally the case, a broadly based income tax could not be imposed because of the administrative problem of valuing imputed income. Because of the serious valuation problems involved we have concluded that, generally speaking, imputed gains from rendering services of benefit to oneself cannot be included in the comprehensive tax base.

The most prevalent example of an imputed property gain is imputed rent. Thus, for the person who has an investment portfolio and is renting accommodation,

the income from the former is taxable while the rent, being an item of personal living expense, is not deductible. If this taxpayer liquidates his investments to acquire a residence, he no longer receives the cash from his investment nor is he required to make the cash expenditure for rent. Nevertheless, his taxable capacity has not been altered, for in effect he still is enjoying the benefit of his capital investment. To ensure that all taxpayers bore their fair proportion of the total tax burden, it would be necessary to impute rental income to this taxpayer.

A similar comparison could be drawn with respect to the ownership or rental of any consumer durable.

The net imputed gain would be equal to the gross rental value of the property less the associated expenses such as property taxes, insurance, depreciation and interest (the "rent" of the capital borrowed to acquire the property).

Obviously, the determination of this net income for owner-occupied dwellings, even if arbitrary rules were established, would be fraught with uncertainty and would entail detailed administrative examination. In fact, it was demonstrated in the United Kingdom, where the taxation of imputed rent ended in 1962 after being an integral part of the tax system for many years, that the problem of assigning a fair market rental value on an equitable basis is virtually insoluble. On the other hand, it must be recognized that the amounts involved are not immaterial 1/ and that they are growing more rapidly than total personal income. The exclusion from income of imputed rent is therefore a substantial tax preference for home ownership.

An incentive of this magnitude leads to inequities between owners and renters. If it were administratively feasible, we would recommend that imputed net rental income be included in the tax base or, to compensate for not doing so, that the deduction of some portion of the rent paid by individuals who do not own their own homes be permitted.

The inequities in not imputing income of owner-occupied homes or in not allowing the deduction of rent are not as extreme in Canada as in the United States. The net rental value is the only part of the benefit which is not included in income in Canada because mortgage interest and property taxes are not deductible in determining taxable income. In the United States the imputed net income is not brought into the tax base, and mortgage interest and property taxes are allowed as deductions from income. This treatment in the United States compounds the problem: it means that taxpayers are allowed to deduct the expenses of generating gains that are not taxed except through the taxation of capital gains. The individual who rents his living accommodation is severely discriminated against.

Because of the administrative difficulty of properly and equitably determining the amount of the net gain, we suggest that imputed rent continue to be omitted from the tax base. Also, because of the administrative complexities involved, we do not recommend the inclusion of any of the other forms of imputed property income.

The foregoing argument has implications for the question of whether municipal taxes should be deductible by home owners. It is often urged that property taxes should be deductible from income on the grounds that this would stimulate home ownership, increase home construction, and make it possible for municipalities to raise more revenue. To the extent that municipal taxes cannot be regarded as a charge for specific municipal services which benefit the property, municipal property taxes are regressive. It can be argued that some relief for such taxes should be granted against income taxes as a deduction or a credit, in order to bring the burden of taxation more closely in line with ability to pay. However, home owners already have an advantage in regard to income tax through the fact that imputed income is not taxed. It may well be desirable to work out techniques that will give municipalities more revenues without raising property taxes, but this objective can be accomplished in other ways that are not so inequitable between taxpayers.

Realization of Gains

Throughout this Report the term realization will be employed to denote the time when there is a disposition of property or when a right to receive income arises. We will later discuss in detail which kinds of transactions will, and which will not, be considered to be dispositions. The word realization will not be restricted to those transactions in which cash has been received or paid, but will also include transactions in which the taxpayer becomes legally entitled to receive, or obligated to make, payment.

The concept of economic power, as we have defined it, clearly calls for including in the tax base not only what the tax unit actually consumes or gives to other tax units, but also the change in the market value of the net assets retained by the unit. Therefore, it is our view that, in principle, unrealized gains should be brought into the tax base. But some rights to, or interests in, property are both unique and infrequently traded, so that it is difficult and expensive to estimate their market value at a particular point in time. Probably the most important and difficult valuation problems are posed by closely held businesses. In addition, taxing changes in the value of assets that have not been sold would in some cases create liquidity problems, for it may be necessary for the individual to dispose of part of his assets in order to obtain cash to meet the tax liability. In many cases this would not be practical, although this problem, to the extent it exists, could be reduced by allowing taxpayers time to pay their taxes. Although we do not believe that the valuation and liquidity problems are insoluble we recommend that at least initially gains should only be taken into the tax base upon realization.

It should be recognized that where only realized net gains and losses are taken into the tax base, it is possible for tax units to postpone taxes. Just as cash in hand is worth more than cash that will be received in the future, so are postponed taxes less costly than present taxes because the cash that would otherwise be turned over to the government can be invested to earn a return until the tax actually has to be paid.

Because tax postponement can be so valuable, taxpayers may be induced to hold property for a longer period than they otherwise would to avoid realization. This "locking in" can also have unfortunate economic effects. Therefore, we recommend that the legislation should be very definite in designating most transactions to be dispositions, and therefore realizations. Thus, virtually all exchanges of property should be treated as leading to realizations. More important, we feel it is imperative that a realization be deemed to take place at least once in each taxpayer's lifetime (or in the lifetime of his surviving spouse) to ensure that postponement does not become indefinite deferment. Therefore, for reasons of taxpayer equity, and to reduce the economic disadvantages of "locking in", we recommend that when an individual makes a gift of property or gives up Canadian residence he should be deemed to have made a disposition of property, except in the case of a gift or legacy to a member of his family unit. When an individual dies a realization should also be deemed to take place, except in the case of property passing to a surviving member of his family unit. If a child comes of age and takes property from his former family unit, there should be a deemed disposition of the property by that unit. The net gain or loss on a deemed disposition or realization would be brought into the tax base of the individual who is deemed to have made the disposition. He would have the opportunity of availing himself of the averaging provisions which we will recommend.

While valuation and liquidity problems are posed by the taxation of unrealized property gains, it is essential to recognize that when we back away from this approach for administrative reasons other complications are created, particularly when the income is earned by an intermediary in which it can be retained in order to postpone personal income tax liabilities.

Intermediaries

If it were possible to bring into each unit's tax base each year the changes in the market value of all its rights to or interests in property,

the tax system could ignore the income of intermediaries, such as corporations, co-operatives and trusts, so far as the interests therein of Canadian residents are concerned. By bringing into each unit's tax base what it actually received from these intermediaries, plus the change in the market value of its property rights, the change in each unit's economic power derived from intermediaries would be fully taxed on a current basis. However, the result of backing away from the taxation of unrealized property gains because of valuation and liquidity problems is that if taxes were not imposed on the income of intermediaries, such income could be retained in an intermediary with no tax until distributed. In this event, individuals would hold property of increased market value, but personal taxes would be postponed until the gains were realized through a later distribution, through the sale of the property, or when a realization of the property was deemed to occur. Because postponed taxes are less onerous than present taxes, and because all individuals would not have the same opportunities for postponement, taxes should be levied on the income of intermediaries that is not allocated to individuals. This is necessary in any event in order to tax the income of intermediaries which is attributable to non-residents.

The specific proposals we put forward in this area involve the following:

1. All forms of business intermediaries should be taxed in the same general way, with differences only to reflect specific problems posed by particular kinds of intermediaries.

2. Full credit should be given to resident tax units for the taxes paid by corporations, mutual organizations and trusts on all the income distributed or allocated to them by the intermediaries.

3. Gains realized from holding interests in intermediaries should be taxed at full personal rates along with other types of property gains.

4. The income allocated to tax units should be taxed and the credit for the tax paid thereon by the intermediary should be allowed when it is allocated, even if it has not been received by the unit.

5. The income of intermediaries that is not allocated to tax units should be taxed at the top personal marginal rate, with the exception of income accumulated in a trust for a specific individual, which should be taxed at his rate.

These proposals should substantially eliminate most of the avenues for personal income tax deferment by Canadians. Although deferment would still be possible in the form of unrealized property gains, many of the difficulties and inequities associated with the present system would disappear. The split rate of corporate income tax, with its attendant problems in dealing with associated corporations, would be eliminated, and the many procedures for minimizing personal tax on the distribution of corporate surplus would also become inapplicable. Differences in the tax treatment of various kinds of intermediaries would largely cease so that sole proprietors, partnerships, corporations and co-operatives would all be taxed in a similar fashion. Similarly, various industries would all be taxed on a similar basis; and the taxation of investment income, regardless of the form in which it was received, or the intermediary through whom it was received, would be uniform. The after-tax rates of return on different kinds of assets and from different kinds of economic activities would be subject to essentially the same tax burden, and would not be taxed at a variety of different rates. Thus, it would no longer be so important to arrange one's affairs in the most advantageous fashion to reduce taxes; much of the uncertainty and complexity of the present system would disappear; competitive inequalities between kinds of business, forms of organization, and forms of saving would be substantially eliminated; and the overall equity of the tax system would be immeasurably improved.

CONCLUSIONS AND RECOMMENDATIONS

NET GAINS FORMULATION

1. We have defined the comprehensive tax base as the market value of goods and services consumed or given away in the taxation year by the tax unit, plus the annual change in the market value of the assets held by the unit. This definition must be reformulated in terms of net gains to make compliance and enforcement possible. Our general conclusions with respect to this reformulation are set out in this chapter, to be developed in more detail in subsequent chapters.

2. Under the net gains formulation, the tax base of each tax unit would include the annual net gains less net losses from the provision of personal services, the disposal of property, the receipt of gifts and legacies, windfall gains, the ownership of property, or any combination of the foregoing.

3. Gross gains can take the form of cash, the acquisition of rights to, and interests in, property, benefits in kind or changes in the value of property held.

4. Expenditures (in cash, or transfers of rights to, or interests in, property) made in the expectation of acquiring a net gain should be deductible from the gross gain in determining the net gain or loss.

5. In the case of transactions between persons not dealing at arm's length net gains and losses should be determined on the basis of fair market value.

PERSONAL EXPENDITURE

6. No personal consumption expenditure should be deducted from gross gains. In particular:

a) general living expenses should not be deducted as expenses;

b) the net losses of operating a business should not be deducted from other income if there is no expectation of generating a net gain;

c) gifts are personal expenses and should not be deducted.

VALUATION OF BENEFITS IN KIND

7. Gross gains that take the form of benefits in kind, rather than cash or rights to, or interests in, property, should be taxed in the same way as other forms of gain. When benefits in kind have an established market value, including them in the tax base is a relatively simple matter; but in many cases there are difficult valuation problems. More stringent reporting requirements for benefits in kind are required, and it will be necessary to adopt arbitrary standards where valuations cannot be made consistently and objectively. We recommend the following general rules:

a) Ordinarily the recipient of a non-cash benefit should bring into his tax base the market value of the benefit.

b) It should be assumed that the recipient of the benefit chose it in preference to the cash required to buy the benefit in the market.

c) When goods and services are received in the performance of one's work the tax base should take into account:

  i) the extra cost of providing goods and services of a greater quantity or better quality than would be purchased by the recipient;

  ii) the reduction in personal expenditures made possible by the consumer goods and services provided by others;

  iii) the extent to which the goods and services were provided to satisfy the individual rather than to produce income.

d) Where a common facility provides a benefit in kind to several people simultaneously, the value of the benefit should be apportioned among them or a special tax should be imposed on the provider of the benefit.

TRANSACTIONS NOT
AT ARM'S LENGTH

8. When the parties to a transaction do not have conflicting interests, the prices at which goods and services are exchanged may provide a gift from one party to another. Because gifts are not deductible to the donor it will be necessary to apply the test of reasonableness to expenses to prevent any element of gift from being deducted. In addition, transactions which take place at other than fair market values should generally be adjusted to prevent the understatement of net gains.

IMPUTED INCOME

9. In principle, the income forgone through the personal use and enjoyment of one's own property and services should be brought into the tax base. Experience in other countries suggests that taxing most forms of imputed income, and in particular the imputed rental income of owner-occupied homes, is impracticable because of valuation problems. To fail to tax imputed income of owner-occupied homes, that is, the income forgone by not renting the house, discriminates against the individual or family that rents accommodation. To allow the deduction of mortgage interest or property taxes would compound this inequity.

REALIZATION OF GAINS

10. To be consistent with the principle of the comprehensive tax base net gains on assets should in principle be brought into income annually, whether the gains were realized or not. This would

preclude tax postponement, and if time were provided to pay the tax on the gains, serious liquidity problems could be avoided. Taxing gains on a realized basis allows for tax postponement and may induce holders of property not to realize their gain in order to avoid the tax. Furthermore, if gains were taxed annually, whether realized or not, the postponement of tax through the retention of income in corporations, trusts and mutual organizations would not pose a problem. There would be no reason to collect tax from these organizations except to obtain tax from non-residents and to prevent tax avoidance.

11. We are convinced, however, that the annual valuation of all property is not practical at this time, and therefore, that property gains should be taxed on realization. However, to prevent permanent deferment we recommend that a realization be deemed to occur on making a gift of property or on giving up Canadian residence. In addition, we recommend that a realization be deemed to take place when an individual dies, except in the case of property passing to a surviving member of his family unit. There should also be a deemed realization to a family unit with respect to property which a child takes with him on leaving the unit.

TREATMENT OF INTERMEDIARIES

12. To prevent tax postponement when only realized property gains are taxed we will recommend that the income of intermediaries, such as corporations, co-operatives and trusts, should ordinarily be taxed at the top marginal personal rate. However, resident tax units should be given a full credit for the taxes collected from the intermediary, when the income of the intermediary is distributed or allocated to them. Accordingly, the tax system would be neutral with respect to the form of business organization, there would be no tax advantage in the retention of earnings, and progressive rates of tax would apply to all income.

REFERENCE

1/ Richard Goode, The Individual Income Tax, Washington: Brookings Institution, 1965, p. 123, has estimated that the net imputed rent (after all expenses and depreciation) of owner-occupied dwellings in the United States is about 2 per cent of personal money income. In addition, interest and property taxes are estimated to be 3 per cent of personal money income.

CHAPTER 9

THE PRESENT AND PROPOSED TAX SYSTEMS

In Chapters 7 and 8 we have taken the position that the Canadian system of taxation should reflect the following basic principles:

1. To be equitable, taxes should be allocated according to ability to pay. This in turn would require the application of progressive rates of tax to a tax base that measured changes in the capacity of an individual to command goods and services for his own use, adjustments being made for non-discretionary expenditures of certain types.

2. The tax base should, as a practical matter, be measured by the net value of virtually all receipts, gains and benefits realized during the year.

3. Not only should net gains of all kinds be taken into account for tax purposes, but they should be taken into account equally and none should be taxed at preferential rates.

4. The capacity to command goods and services for his own use is an attribute of the individual. Intermediaries, such as corporations, co-operatives and trusts, do not have such capacity but it is necessary to collect tax from them to prevent postponement of tax by the individuals they represent. Intermediaries should, therefore, be taxed on the comprehensive tax base and the taxation of intermediaries should, as far as possible, be integrated with the taxation of individuals.

In this chapter we propose to consider in a very general way the extent to which the present Canadian federal system of income taxation is consistent with these principles and, at the risk of over-simplification, we propose to indicate how such principles might be applied in the future. The discussion in this chapter will be brief, and subsequent chapters of the Report will deal in greater detail with most of the points we mention here.

AMOUNTS INCLUDED IN THE TAX BASE

The Present System

There has been a federal income tax in Canada since the Income War Tax Act was passed in 1917. The successor statute, under which this tax is currently imposed, is the Income Tax Act, enacted in 1948 and effective for the 1949 and subsequent taxation years.

Receipts, gains and benefits of various kinds are at present brought into income for the purposes of the tax, but in computing income certain amounts may be deducted; income is, therefore, the balance remaining after any permissible deductions are subtracted from what is brought in. Once income has been computed in this manner, concessionary allowances of various types may ordinarily be deducted in computing taxable income, the amount on which the tax is imposed. Examples of concessionary allowances are the deductions based on the single or marital status of the individual, and on the number and characteristics of his children or other dependants, as well as donations to charity, medical expenses and some educational costs.

Under Part I of the Act, tax is imposed on all of the taxable income of residents and certain taxable income of non-residents of Canada. In the case of residents, income from sources both inside and outside Canada is brought into the tax base, but they are entitled to credits against the Canadian tax on such income for foreign taxes paid. If non-residents are employed in Canada, or carry on business in Canada, they are taxed on their taxable income earned in Canada. Non-resident corporations carrying on business in Canada are also subject to a further tax under Part IIIA of the Act. In addition, under Part III of the Act, non-residents are subject to Canadian taxes withheld by the payer in respect of specified kinds of income such as interest, dividends, rents and royalties paid to them by Canadian residents. The taxation of residents on foreign-source income and of non-residents on Canadian-source income is affected by international

tax agreements between Canada and a number of other countries. The international aspects of income taxation are dealt with in Chapter 26.

In considering the present concept of income for tax purposes, it is necessary first to deal with what is brought into income. We have already mentioned that in computing income certain deductions may be permitted and that after income is computed certain concessionary allowances may be deducted in determining taxable income. This is the amount that is taxed under the principal charging section of the Act 1/. We shall consider both of these types of deductions in due course.

The first point to be made with respect to what is brought into income is that the word "income" is nowhere defined in the legislation or for that matter in the numerous decisions of the courts in taxation cases. The Act does provide that a taxpayer's income for a taxation year is his income for the year from all sources, and that it includes income from businesses, property, and offices and employments 2/. It goes on to say that income from a business or property is the profit therefrom for the year, subject to other provisions of the Act 3/. The term "profit" is not defined in the Act, but it is well established in legal decisions as meaning profit as determined under recognized accounting practices, 4/ subject to the express provisions of the statute and to any decisions of the courts to the effect that particular accounting practices do not apply for tax purposes 5/. The Act also indicates with some particularity what constitutes income from an office or employment 6/. In fact, these three sources produce the great bulk of the income taxed under the Act. The determination of what gains constitute income from one or another of these sources has been the subject of many decisions of the courts. We discuss employment income in Chapter 14, income from property in Chapter 15, and business income in Chapter 22.

Apart from the general provisions referred to, there are many sections of the Act which bring receipts, gains and benefits of various kinds into

income 7/. Some of these amounts would doubtless be taxed in any event as income from one of the three enumerated sources previously referred to. Others have been specifically taxed under Canadian tax legislation from the outset. Still others have been added over the years on a piecemeal basis to preserve the integrity of, or to add to, the tax base. There have been a good many instances of additions since the enactment of the present Act in 1948. 8/ A number of receipts, gains and benefits, which are generally of a minor nature, are expressly excluded from income under the Act 9/.

The general provision in section 3 of the Act that "income" is income from all sources is susceptible of a very broad interpretation and might have permitted the bringing into tax of receipts, gains and benefits not expressly referred to in any of the specified sources mentioned in the Act. In fact, the corresponding provision of the Income War Tax Act 10/ and the present provision have been given very limited significance in the administration of the legislation and in their interpretation by the courts. The result is that, with few exceptions, to constitute income in Canada today an amount must either be derived from one of the three main sources mentioned or be of a type that is expressly brought into tax under the Act.

The Distinction Between Capital and Income. One of the fundamental rules of the present Canadian system is that a distinction must be drawn between gains of an income and those of a capital nature. Only the former are brought into tax. Capital gains have never been taxed under Canadian income tax law, although some gains that had at certain times been regarded as being of a capital nature have lost that character by legislative amendments or by court decisions. The exclusion of capital gains from tax is not provided for in the legislation, and the terms "capital" or "capital gains" are not defined therein; but the principle of the exclusion is clearly established in decisions of the courts.

The most important application of this general rule is that gains

arising from the disposition of property, other than in the course of business, are not ordinarily taxable.

However, there are many types of gains that do not necessarily arise from the disposition of property but which may be treated as being of a capital nature and are therefore not regarded as income. Thus, compensation for loss of an office or employment, which is now treated as income, was not originally taxable. However, by statutory provision, retiring allowances which include compensation for loss of office or employment must be brought into income 11/. The proceeds of life insurance policies are ordinarily treated as capital receipts. Also, the position under the decided cases appears to be that under most circumstances if indebtedness of a business nature is forgiven, the amount forgiven is not income of the debtor 12/.

Many other amounts may be treated as income or capital, depending on the circumstances; examples are premiums for the granting of leases, discounts or premiums on loans, amounts received as a result of the breach or cancellation of a contract, the proceeds of insurance (apart from life insurance), foreign exchange profits, payments of damages, government subsidy payments, and the proceeds of expropriation of property. This list is by no means exhaustive. In many cases difficulties have arisen in determining whether particular gains, in the circumstances of particular cases, are properly regarded as being of an income or of a capital nature, and disputes of this sort continue to arise.

Other Gains Not Brought Into Income. Other items which are not treated in Canada as income include gifts and inheritances, and receipts of a windfall nature such as lottery prizes and winnings from occasional bets.

Influence of the United Kingdom. In considering the Canadian tax system, it is desirable to keep in mind that it has been greatly influenced by the tax system of the United Kingdom. Income tax was introduced in the United

Kingdom in 1799 and has been imposed there without interruption since 1842. The word income is not defined in the legislation, but the tax applies to income from particular sources and to other designated types of receipts. There are basic similarities, although there are also significant differences, between the tax bases in the two countries. The United Kingdom legislation as amended over the years has been extensively interpreted in judicial decisions. These decisions have had persuasive effect in the Canadian courts, with the result that many of the principles and rules established in United Kingdom jurisprudence have been followed in Canada 13/. The same is true to a lesser extent of decisions of tribunals in other parts of the Commonwealth.

The influence of the United Kingdom system may serve to explain why, as indicated above, the broadly worded "sweeping-up" clause in the Canadian Act "income from all sources" has had little real significance. Under the United Kingdom statutes only amounts of a specified type or referable to a specified source are subject to tax. The only provision in the United Kingdom legislation 14/ which might have been treated as a broad sweeping-up clause, bringing additional types of income into tax, has been given a restricted interpretation by the United Kingdom courts. In other words, the fact that in the United Kingdom only income from the specified sources and receipts of the kinds specifically mentioned were taxable, and the fact that the United Kingdom courts approached taxability with this in mind, probably contributed to the restricted interpretation of the sweeping-up clause in the Canadian legislation.

The distinction between amounts of an income nature and those of a capital nature for tax purposes was established in the United Kingdom long before income tax was first imposed in Canada. Even there, however, the basis for the distinction is not entirely clear. It may be that introduction of an income tax in that country when its economy was primarily agricultural gave rise to the view that income was the yield from a

productive source. The British came to regard the basic sources of income, that is, property, businesses, and offices and employments, as things which were inherently productive of income, and as being capital substances from which income emerged 15/. The source itself and the proceeds of a disposition of such a source were capital and not subject to income tax; it was the yield from the source which was income and subject to tax. The analogy often used was that of the fruit and the tree. The fruit (or its value) was income, but the tree (or the proceeds of its disposition) was capital and not income.

Another factor contributing to the distinction may have been the distinction drawn under the United Kingdom law of trusts between the rights of the beneficiaries entitled to the income from, and the rights of those entitled to the capital of, the trust property. There may have been other factors. Whatever its origin, however, the basic United Kingdom distinction between income and capital receipts for tax purposes was accepted by the Canadian courts from the time income tax was first introduced in Canada.

In the United Kingdom, gifts, inheritances and windfalls have not been subject to income tax. Here again, the reason for their original exclusion is not clear, although a contributing factor may have been that gifts and windfalls did not emanate from a specified source held by the recipient. In any event the Canadian practice has again followed that of the United Kingdom.

Influence of the United States. The United States income tax law has had relatively little influence on the taxation of income in Canada. From the point of view of what is included in income, there has been a remarkable contrast between the development of the Canadian and United States systems. The present United States income tax was introduced in 1913, and under the current legislation tax is imposed on "all income from whatever source derived", including a list of specified items. The Supreme Court of the

United States has indicated that under this provision it is prepared to treat all receipts which constitute an accession to a taxpayer's wealth as income, except those receipts excluded by specific provisions of the legislation or by settled custom 16/. The result is that, starting with general words which are quite similar to the Canadian terminology, that is to say, "income ... from all sources", the United States courts have evolved a concept of income which embraces all accessions to wealth except those expressly excluded in the legislation. However, the Canadian courts have tended to bring into tax little which is not income from the three specific sources of income, or which is not brought in by other express provisions of the statute. It may be noted in particular that under the United States legislation, capital gains were held by the courts to be income in the ordinary sense. The preferential rates to which capital gains are now subject in that country were provided for by legislative amendment in later years. It will be noted that gifts and inheritances probably would also be income except that they are expressly excluded from the tax on income under the United States legislation.

Appraisal of Present System. The present Canadian tax system, when examined from the point of view of what is brought into tax, is seriously defective in many respects.

The Act does not contain, nor have the courts in interpreting the legislation evolved, any clear, consistent concept of income. What is brought into income is determined under a collection of rules which have been developed over a period of time, to a considerable extent on an *ad hoc* basis; some of them are statutory, others are based on the practice of the tax authorities in administering the legislation, and still others are based on judicial interpretation of the statutes.

It is clear that many items which increase the economic power of the recipient, that is, his ability to pay, and which in our view should in equity be taxed, are not included in the present income tax base. These

include, as we have noted, certain gains from the disposition of property, other capital receipts, the proceeds of life insurance, the benefit arising from the forgiveness of business indebtedness, gifts, inheritances and windfall receipts. Other illustrations of exclusions from the tax base and of the preferential treatment of particular types of income will appear in the chapters which follow. The omission of these items from the present tax base is, we are convinced, most inequitable.

It is not surprising in the circumstances that great uncertainty has existed over the years as to what receipts, gains and benefits are properly regarded as being of an income nature for tax purposes. This has led to continual litigation and to frequent changes in the statute law. It has also meant that in many instances the form rather than the substance of a transaction has been important for tax purposes. By careful attention to matters of form, liability to tax has been avoided or minimized. To cite a simple example, the sale of the assets of a company may lead to substantial tax, while the sale of the shares of the company will ordinarily result in a tax-free gain. We believe that these difficulties, and the resultant inequities of the present system, cannot be overcome without radical changes in the present system. What is required is a new comprehensive tax base.

The Proposed System

We would have preferred, in order to emphasize the radical differences between the comprehensive tax base we recommend and the present concept of income, to use some word other than income to describe the basis for tax. We have not, however, been able to find any obviously suitable word and are conscious that there are arguments for the retention of the traditional term. We will proceed in this Report, therefore, on the basis that what is being taxed under the comprehensive tax base will be termed "income" and that the tax with which we are concerned is an income tax. We will use the terms "comprehensive tax base", "profit" and "net gain" interchangeably with the word "income".

Amounts Included in Income. From what we have said earlier in this and previous chapters, it will be clear that what we mean by income is the net value of virtually all receipts, gains and benefits realized during the year. By this definition we intend to bring into tax the value of the realized changes in the capacity of an individual to command goods and services for his own use. We have also made it plain that intermediaries, such as corporations, co-operatives and trusts, should be treated as having income and should be taxed thereon in order to prevent postponement of tax by the resident individuals who hold residual claims against them and in order to impose tax on non-residents who hold residual claims against them. The taxation of intermediaries should be integrated so far as possible with the taxation of resident individuals. Because we speak of net values, it will be evident that we contemplate that, as under the present system, income will be the balance remaining after certain deductions are taken from the amounts which are brought into income.

It seems to us that in any legislation that may implement our proposals the term "income" should be defined in such a way as to give effect to the basic concept we have just mentioned, that is, to include in the tax base all realized changes in ability to pay. In principle, it should not be necessary to specify any particular kinds of income as being subject to tax, for all net gains, as defined, would be brought in under the general all-inclusive definition of income. However, we think it would be desirable, in order to make the implications of the charging section clear to taxpayers at the outset, to specify explicitly in the statute, without limiting the generality of the initial definition, that particular kinds of income should be taxed. This approach is quite important to ensure that all kinds of net gains are taxable.

Under our approach, what is brought into income under the present system would continue to be taxable, but other kinds of receipts, gains and benefits, some of them of major significance, would also be subject to tax.

Income from the three major sources, business. property and an office or employment brought into tax under the present system would continue to form part of the comprehensive tax base and, in subsequent chapters, we will discuss the taxation of these kinds of income under the present system and under our proposals.

We have mentioned that many kinds of gains not attributable to these three sources are taxed under the present system. We anticipate that such gains will continue to be taxable.

Property Gains. We have referred to the fact that so-called capital gains (gains from the disposition of property) are not now taxable. It is clear to us that such gains add to the economic power or ability to pay of the recipient and that they should be taxed in the same way as other income. The only exception we propose is a lifetime exemption, not exceeding $25,000, on gains from the sale of certain residential, including farm, properties.

The comprehensive tax base would also bring into tax other net gains which have heretofore been treated as of a capital nature. Thus, the profit realized on the sale of a business would be income for tax purposes under the proposed tax system. We will discuss the treatment of life insurance from the point of view of the policyholder and will recommend that eventually the net proceeds of such policies should be brought into income. The forgiveness of business indebtedness adds to the economic power of the debtor and should therefore be treated as income. The distinction now drawn between income and capital receipts with respect to such items as lease premiums, loan premiums or discounts, amounts received upon the breach or cancellation of contracts, the proceeds of insurance other than life insurance, profits on foreign exchange, damage payments, government subsidy payments, and the proceeds of expropriation of property should, we believe. disappear, and all should be brought into the tax base.

Gifts and Inheritances. Gifts and inheritances obviously add to the economic power of the recipient. We therefore recommend that, with the major exception of transfers between members of a family unit and with a number of relatively minor exceptions, they should be treated as income for tax purposes. The present gift tax and estate tax would therefore be abolished. We will discuss the treatment of gifts and inheritances and the related question of the taxation of trusts and their beneficiaries in later chapters.

Windfall Gains. Windfall gains of all kinds should, in our opinion, be included in income. These would include sweepstake winnings and gambling gains.

Source of Income. We have indicated that we propose taxing income of all kinds and we have specified particular kinds of income which we think should be taxed. A taxpayer may, of course, have a number of receipts which constitute income of the same kind. He may, for example, in a particular year, hold a number of properties which are productive of income, operate two or more businesses, receive several gifts, or benefit from government transfer payments of more than one type. We will use the term "source" of income to cover anything that leads to the receipt of income, and we emphasize that we do not confine the term to the United Kingdom meaning referred to previously of a capital substance from which income emerges. It will be necessary for one reason or another under our proposals, as it is under the present law, to determine the income from a particular source for a particular period.

Exclusions from Income. Under our proposals, few net gains would be excluded from the comprehensive tax base. However, we have suggested some exclusions, primarily for administrative reasons, to reduce the record-keeping problems of accounting for small amounts. The most substantial exclusion would arise from the proposed treatment of gains arising from dispositions of certain residential, including farm, properties. We have suggested a lifetime exemption of $25,000 of gains on the disposition of such property. We will suggest that, initially, mortality gains and losses

on Canadian life insurance policies which are incurred by the tax unit that paid the premiums should be excluded from income. However, once a transitional period had elapsed, and the impact of our other proposals for life insurance had been assimilated, the net proceeds of life insurance policies (after deduction of premiums paid and investment income taxed) should be brought into income. In addition, we have proposed that small exemptions should apply to the earned income of dependent members of the family unit and to gifts.

We mentioned above that a number of relatively minor items are now expressly excluded from income under the Act 17/. We would like to see most of these exemptions eliminated and will refer to most of them in Chapter 18.

Effects of Adopting the Comprehensive Tax Base. It is our view that the adoption of the comprehensive tax base we recommend would greatly improve taxpayer equity by bringing virtually all increases in economic power into tax. Such a tax base would also have the very desirable ancillary benefit of substantially eliminating the uncertainty, and the various opportunities for tax minimization and avoidance, that we have found in the present system, because virtually all net gains would be taxable to residents at full personal rates. The withholding of tax by intermediaries at maximum personal rates is primarily a collection device, but it does have important additional advantages. Thus, the form in which, or the time when, income is distributed by an intermediary would lose much of its significance.

Methods of Computing Income

Because the income tax is an annual tax, the year in which receipts and expenses are to be brought into account is a matter of importance to the taxpayer and the tax authorities.

Both the cash and the accrual methods of computing income are in common use. Under the cash method, gains are included in income when they are

received and expenses are deducted from income when they are paid. Under the accrual method, gains that are receivable, in the sense that the right to receive them has arisen, are brought into income notwithstanding that they have not actually been received. Similarly, expenses which have been incurred, in the sense that the obligation to pay them has arisen, are deducted even though they have not actually been paid.

In determining income for tax purposes, accounting methods are, of course, subject to the express provisions of the taxing statute and to the right of the courts to determine whether or not they are appropriate in the computation of income for such purposes. Under the Act it is expressly provided that certain kinds of income are taxable when received, and it follows that such income is computed, subject to the terms of the Act, on the cash basis. Income from employment is one such instance 18/. Other examples are dividends, annuity payments and pension and similar benefits, but many others could be cited 19/. On the other hand, interest is to be brought in when received or receivable, depending upon the method regularly followed by the taxpayer in computing his profit 20/. In the determination of profit from a business, it is generally accepted that the accrual method is the appropriate method 21/. However, where a taxpayer is engaged in farming or practises a profession, the Act expressly permits him to adopt what is substantially the cash method of computing his income 22/. There has been a reasonable amount of latitude in the choice of a method of computing other kinds of income, provided the method adopted accurately reflects profit and is consistently applied.

We consider that the method of computing income for tax purposes should continue to vary according to the kind of income involved. The methods we recommend are designed to ensure certainty and overall equity between taxpayers. The attainment of the latter objective will require the use of some specific rules to eliminate deferment of income.

We think that in general, income of all kinds, other than from employment, business and property, should be brought into the tax base when received so that, in effect, the cash basis would apply.

Income from employment should in our view ordinarily be taxed when received; but in Chapter 14 we will suggest special rules for the taxation of amounts not actually received by an employee but which have been set aside by the employer for the benefit of the employee.

Income from business should, as we have mentioned, be the profit therefrom for the year, and we think that such profit should be determined under the accrual method in all cases except that in specified cases individuals who derive income from farming or a profession with annual revenue below a specified limit should be entitled to continue to use the cash method.

Our proposals with regard to income from property vary as between gains on the disposition of property and income from the holding of property. Gains on the disposition of property should consist of the excess of the net proceeds of disposition over the cost basis of the property and should be brought into account at the time the disposition occurs or is deemed to occur. Income from the holding of property should generally be included either when it is received or when it is receivable. In Chapter 15 we will, however, propose additional rules with respect to the taxation of certain income, for example, interest, which is set aside for the benefit of a taxpayer although it is not actually received or receivable by him.

The method used to compute a loss from a source should, of course, be the same as the method used to compute income from the same source.

We have pointed out that under the cash method amounts of an income nature are included in income when, but only when, they are received. Unfortunately, there is at present some uncertainty as to what constitutes receipt or realization of income. For example, receipt of a cheque will ordinarily be considered to be receipt of cash, and, similarly, amounts

placed to the credit of the taxpayer will usually be regarded as having been received by him if he has agreed to this mode of payment and if the amount is at his disposal. However, this result has not been followed in all cases and some taxpayers have obtained an advantage by manipulating the date of receipt.

In many cases the debtor will be able to deduct the amount owing because he is on the accrual basis, but the creditor will not be obliged to take it into income because he is on the cash basis. In our view this result is inequitable and should be corrected, at least in those cases where the parties concerned are not dealing at arm's length. Accordingly, we recommend that the rules now contained in section 18 of the Act should be amended to provide, in effect, that no taxpayer is entitled to a deduction of any amount payable to a person who is resident or carrying on business in Canada and with whom the taxpayer was not dealing at arm's length, unless in the year of deduction that amount is included in the income of the creditor. Subject to the above modifications, the present provisions of section 18 appear to be satisfactory.

However, the postponement of income through the use of the cash method is not limited to transactions between persons who are not dealing at arm's length. We have mentioned the introduction of special rules concerning employment income and some property income in those cases where the recipient is usually on a cash basis and currently does not record any income until payment is actually received. Such a deferment of tax is inequitable, and either the deduction to the payer should be denied, a tax should be withheld at source, or the beneficiary should be required to include the amount in income. We concluded that one of the latter two alternatives is preferable and later recommend the one that appears most appropriate in each of the cases which we discuss in the relevant chapters.

At the present time it is generally acknowledged that income will arise if it is received in money or in money's worth. The rules which have been

developed by the courts, subject to the present statutory provisions, such as section 24, appear to us to be satisfactory.

Another question of general application with respect to the receipt of income will arise when a taxpayer receives an amount subject to an obligation. The general problem in cases of this nature is whether the taxpayer's right to the amount in question is absolute and under no restriction, contractual or otherwise, as to its disposition, use or enjoyment. For example, if property has been left to a beneficiary under terms that require him to pay an annuity to some other person, the general rule is that the beneficiary will be taxable on the entire amount of income, and will not be able to make any deduction for the annuity payments. However, if the property is given subject to a charge or trust to secure payment of the annuity, the beneficiary may be able to assert successfully that, to the extent of the amount charged or held in trust for another, the annuity never formed part of his income and accordingly is not taxable to him. In Chapter 17, we suggest that any payment required to be made as a condition of receiving a gift should be deductible therefrom.

Application of Accounting Practices in Determining Income from Business or Property

Under the present legislation, income from a business or property, subject to other provisions of the Act, is the profit therefrom for the year 23/. Profit for this purpose has been found by the courts to mean profit as determined under recognized accounting practices, subject to any overriding provisions of the statute or decisions of the courts. In 1948, when the present legislation was being drafted, it was proposed that the Act should include a provision to the effect that, except as otherwise provided in the statute, income from a business or property should be determined in accordance with generally accepted accounting principles. This approach was eventually abandoned in favour of the present provision, in part because of uncertainty as to the accounting principles which could be said to be generally accepted.

Having regard to the passage of time since the present Act came into effect, we thought it advisable to question the Canadian Institute of Chartered Accountants, as a group representative of the accounting profession, as to whether the determination of business and property income for tax purposes should be based on recognized accounting practices. As will appear later, their conclusion was adverse to this approach. We have decided that we should follow their conclusion. A letter from the Canadian Institute of Chartered Accountants is referred to in more detail in Chapter 22 and is reproduced in Appendix A to Volume 4.

Generally speaking, we recommend a somewhat greater reliance on accounting practices. We discuss this in Chapter 22. However, it will still be necessary for the statute to specify some rules with respect to the determination of annual income.

Timing of Revenue. The Act now contains a general prohibition on the deduction of amounts transferred to reserves, except as expressly permitted by the Act 24/. We think that such a provision is no longer necessary because of the development of accounting practices, and we recommend that it should be deleted.

For the same reason, we suggest that the present provisions of the Act dealing with doubtful and bad accounts receivable 25/ and unearned income 26/ should be repealed and replaced by general provisions to the effect that such items should be reasonable. However, specific, statutory provisions may be necessary for instalment sales, guarantees, indemnities and warranties. These matters are discussed more fully in Chapter 22. We also suggest in Chapter 24 that specific provisions be permitted to banks and in respect of mortgages.

DEDUCTIONS IN COMPUTING INCOME

The Present Tax System

We have already pointed out that income for tax purposes is the balance

remaining after any permitted deductions are subtracted from what must be brought into the tax base. We have also mentioned that income is not defined in the Act. Nor is there a provision in the present legislation which explicitly confers a general right to deductions and establishes a concept of net income. The legislation does, however, contain provisions permitting some deductions and prohibiting others, either generally or for particular kinds of items. Decisions of the courts have also thrown light on what is, or is not, deductible in particular situations. We will now refer to the principal general statutory provisions of this kind.

In Computing Income from Employment. So far as deductions in computing employment income are concerned, the Act is quite specific. It lists particular deductions which may be taken and states that no other deductions whatsoever may be made in computing such income 27/. It should be noted, however, that there are certain deductions which may be made by an officer or employee in computing income generally in addition to those that relate to the computation of income from his office or employment. Nevertheless, the present restrictions on deductions from employment income are more stringent than those applicable in computing income from business or property.

In Computing Income from Business and Property and Other Sources. Income from a business or property is the profit therefrom for the year 28/. Profit is determined according to recognized accounting practices, subject to any express provisions of the Act and to any applicable legal decisions. Under recognized accounting practices, profits are ascertained by deducting from the income earned the cost of earning it. On this basis, the first step in determining whether a particular amount is deductible in computing income from a business or property is to determine whether it would be deductible in determining profit under recognized accounting practices; if it is not, that is the end of the matter unless the deduction is expressly permitted by the legislation. If, however, the deduction is permitted under recognized accounting practices, it is then necessary to determine whether it is prohibited or limited by any express provision of the Act.

The first provision of the present Act to be considered in this connection is section 12(1)(a) which states that in computing income no deduction may be made in respect of "an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer" 29/. The Income War Tax Act provided that in computing profits or gains a deduction should not be allowed in respect of "disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income" 30/.

The provision of the earlier Act was quite restrictive and, for business income at any rate, was construed by the courts in a number of cases as precluding the deduction of expenses unless they were, in effect, working expenses directly related to the earning of the income. This narrow construction was, however, not uniformly adopted by the courts. Under the present provision, the prohibition applies to expenditures not made "for the purpose of gaining or producing income". It now seems clear from decisions under this provision that the narrow construction referred to has been overridden. If the purpose of an expenditure bears a reasonable relationship to the production of income, its deduction will not be prohibited by section 12(1)(a). It is not necessary to show a causal connection between such an expenditure and the actual receipt of income 31/. Whether a particular expenditure was made for the purpose of gaining or producing income from a business or property must be determined on the facts of the particular case.

Section 12(1)(a) of the Act is open to the interpretation that it prohibits any deduction in the computation of income unless the income is from business or property. As we have seen, this is because it provides that outlays or expenses may not be deducted except to the extent they are made to gain income from property or a business. If this interpretation is correct, the resultant prohibition on deductions in computing income of other kinds and from other sources is of general application and is subject only to

provisions such as sections 5 and 11 which expressly authorize particular deductions from employment income and other income. This interpretation of the effect of section 12(1)(a) was disapproved in a recent Exchequer Court decision 32/. The right of a taxpayer to a particular deduction was considered both on the basis that the expenditure was made in a business venture and on the alternative basis that it related to a source of income other than business, property or employment. The view was expressed in the reasons for judgment that, on the alternative basis mentioned, section 12(1)(a) should not be interpreted as prohibiting the deduction of expenses involved in earning income from sources other than business and property. Under this approach, section 12(1)(a) would be concerned only with income from business or property.

In addition to the restrictions of section 12(1)(a), there are other prohibitions and limitations in the Act which are applicable to expenditures generally, and not simply to expenditures related to particular kinds of income.

The first of these is the provision which prohibits the deduction of capital losses or expenditures or of allowances in respect of depreciation, obsolescence or depletion, except as expressly permitted by the Act 33/. We have seen that the exclusion from income of capital gains or receipts was established in the courts rather than by statute. In the case of capital losses or expenditures, however, there is a statutory denial of a deduction. Such denial extends not only to losses on the disposition of property, but to other losses and expenditures which are regarded as being of a capital nature. Just as certain items on the receipts side are income or capital according to the particular circumstances, many expenditures and losses are of an income or capital nature, depending on the facts of the case. Over the years there has been a very large amount of litigation on the question as to whether particular items were, or were not, deductible under this clause or its predecessor. There is continuing uncertainty in this area.

In some cases where expenditures of a capital nature are made, the asset acquired or the amount expended is eligible for capital cost allowance as permitted under the legislation, 34/ so that the amount involved is deductible over a period in computing income for tax purposes. However, there are a number of types of expenditures which are quite properly made in the course of carrying on business and which are not deductible from income either currently because they are of a capital nature, or over a period of time because capital cost allowance regulations do not apply to them. They have become known as "nothings". We refer to this problem at greater length later in this chapter.

Exempt Income. Another general prohibition on deductions in the present legislation relates to expenditures made to produce exempt income or in connection with property the income from which would be exempt 35/. In practice, the principal importance of this provision is that it precludes the deduction of interest on money borrowed by one resident corporation to purchase shares of another resident corporation because, under the Act, dividends on the shares received by the purchaser are exempt income 36/.

Personal or Living Expenses. Under a further provision of the Act the deduction of personal or living expenses of a taxpayer is specifically prohibited 37/. The provision contains an exception for travelling expenses incurred by the taxpayer while away from home in the course of carrying on his business.

Unreasonable Expenditures. Another statutory restriction on deductions is that which provides that expenditures which would otherwise be deductible may not be deducted except to the extent that they are reasonable in the circumstances 38/. This provision permits the administration to challenge a particular expenditure as excessive but leaves the taxpayer the right to substantiate it in the courts.

Expenditures Which Artificially Reduce Income. The last prohibition on

deductions to which we will refer here is the provision that a disbursement or expense may not be deducted if this would unduly or artificially reduce the income 39/. In view of the other restrictions we have discussed it is unlikely that this provision would be applicable, except in extreme cases.

Specifically Permitted Deductions. Having referred to the more important general restrictions on deductions contained in the Act, we must mention that there are other provisions of the Act which expressly permit certain deductions to be made in computing income. Reference has already been made to the fact that particular deductions may be taken in computing employment income. Many deductions are expressly permitted under section 11 of the Act which applies notwithstanding certain of the general restrictions on deductions which we have mentioned 40/. The deductions provided for under section 11 include amounts in respect of depreciation, depletion, interest, doubtful accounts of a business, contributions under employee benefit plans, and alimony and maintenance payments as well as many others. In many cases there are limitations or restrictions relating either to the circumstances in which they may be taken or to the amounts which are deductible. Other sections of the Act also provide for the deductibility of amounts of particular kinds. Many of these provisions will be referred to later in this Report.

Adequacy of the Present Deduction Provisions. Our view is that the present position with regard to the deduction of expenses for tax purposes leaves much to be desired. Deductibility does not appear to be based on any general principle. In the area of employment income the rules are unduly restrictive. In determining income from business or property, the position with respect to the deduction of current expenditures does not now seem to be unreasonable. However, just as we consider that gains on the disposition of property and other capital receipts should be included in income, so are we critical of the principle that losses on the disposition of property and other losses or expenditures of a capital nature are not deductible at

some time. It is clearly unreasonable that many of the so-called "nothings" should be denied deductibility either currently or over a period. The confusion and uncertainty which arise as to the deductibility of expenses and losses under the present system seem to be no less than that existing on the revenue side. We think that this confusion and uncertainty will be materially dispelled under our proposals.

The Proposed System

The question of deductions becomes more important when additional kinds of income are brought into the tax base. In keeping with our approach that all income, in the broad sense in which we use the term, should be taxable, it is clear that in principle all expenditures, other than those that confer personal benefits on the taxpayer, should be deductible in the determination of income. The two basic problems in this area are to devise methods of preventing the deduction of personal expenditures and to decide when non-personal expenditures should be deducted. Similar problems exist in formulating principles for the treatment of losses that are both equitable and administratively feasible. The comprehensive tax base logically requires the deduction of all losses unless they in fact represent a type of personal expenditure. The question of when losses should be deductible is just as significant as determining when expenditures should be deductible. The problems of the timing of deductions and the treatment of losses are dealt with under separate headings later in this chapter.

As we discussed in the previous chapter, we consider it important that taxpayers be prevented from deducting personal expenditures in the determination of taxable income. We propose to tax the increase in each taxpayer's capacity to command goods and services for his own use. To allow the deduction of expenses that confer personal benefit on the taxpayer, either because they provide tax-free goods or services for the taxpayer, or because they constitute gifts from the taxpayer to others, would result in a serious understatement of the tax base of some taxpayers. Although

the objective is perfectly clear, it is a difficult task to design a simple and fully enforceable system that will preclude the deduction of personal expenses.

In our view the problem should be approached in two ways simultaneously. There should be general rules that deny the deduction of personal expenditures, and there should be specific provisions in the legislation that explicitly deny particular kinds of expenditures where there is likely to be a substantial personal benefit involved. To rely solely upon general rules would make full enforcement virtually impossible; to rely solely upon specific provisions denying deductions would place a premium on the skilful manipulation of the affairs of the taxpayer to avoid the letter of the prohibition.

It seems to us that there are three general rules which should govern the deductibility of expenditures, regardless of the type of income involved. We will deal with each of them briefly here, but their application to income of particular kinds will be dealt with in more detail in subsequent chapters where it will be made clear that the general rules will have to be supplemented by specific rules applicable to income received from certain sources. The first of these rules has both positive and negative aspects in that it contemplates that certain expenditures should and others should not be deductible. The other two rules are essentially restrictive in that they disallow expenditures which might otherwise be deductible.

<ins>Expenditures "Reasonably Related" to the Gaining of Income</ins>. The first general rule is that expenditures should be deductible only if they are reasonably related to the gaining or producing of income. The positive side of this rule is that all expenditures reasonably related to the gaining or producing of income should be deductible; the negative side is that any expenditures not so related should not be deductible. It seems to us that both aspects might well be reflected in the legislation. We emphasize that under our proposals the present distinction between income expenditures and so-called capital expenditures would disappear and therefore would not affect

entitlement to deductibility, although, of course, questions of the timing of deductions would remain.

The words "reasonably related to the gaining or producing of income" are intended to state a general principle rather than to suggest any specific wording for the statute. We doubt that the terminology now used in section 12(1)(a), which is "for the purpose of gaining or producing income", would be suitable under the comprehensive tax base, even if it were clearly made applicable to income of all kinds and not only to income from business or property. The comprehensive tax base would bring into income such items as gifts which may not result from purposeful activity of the recipient but from which deductions may be appropriate. In any event, we emphasize that whatever words are used should be capable of a broad interpretation so that, subject to any other statutory rules, any expenditure made in the expectation of producing a net gain or as a consequence of an activity or situation which might reasonably be expected to produce a net gain would be deductible.

For a number of reasons, we have concluded that there must be a restriction on deductions of the type implied in this general rule. Cases decided under section 12(1)(a) have shown that taxpayers claim deductions when their relationship to the earning of income is too remote to warrant deductibility under a taxing statute. What constitutes a satisfactory relationship should, we think, be determined on the facts of the particular case. As we have already stated, gifts should not be deductible to the donor, because they are, in substance, expenditures of a personal nature. The "reasonably related" rule should preclude the deduction of that part of an expenditure that constitutes a gift by the taxpayer rather than a payment for goods and services at market prices.

Summing up the position under the first general rule, we think that on the positive side it gives the taxpayer a statutory right to deductibility which is broader than any he now has. On the negative side, it gives the tax authorities a type of residual protection against the deduction of

expenditures which the taxpayer may think are reasonably related to the earning of income but which the tax authorities, and, in the event of dispute, the courts, may consider not to be so related. This rule would result, among other things, in the disallowance of some expenditures which are of a personal nature and are not related to the earning of income, and will be supplemented in this respect by our other general rules.

Unreasonable Expenditures. The second general rule is related to the first and would assert that expenditures otherwise deductible should not be allowed to the extent that they are unreasonable in the circumstances. This rule is concerned primarily with the amount of an expenditure whereas the first relates more to the nature of the expenditure. The rule has a parallel in the present legislation, 41/ and we consider that it is also necessary under the comprehensive tax base to prevent tax avoidance.

Expenditures of a Personal Nature. The third general rule is that expenditures of a personal nature, that is, expenditures made for personal use or consumption, should not be deductible. The present legislation prohibits the deduction of personal or living expenses 42/. Under the comprehensive tax base this rule would have a very broad application. Thus, it should exclude the deduction at any time of any part of the cost of the acquisition of property for personal use or consumption, except in computing the gain or loss arising from the disposition of the property. It would also exclude the cost of carrying or maintaining such property. Property acquired for personal use or consumption may, of course, later be used for some other purpose, and vice versa, and we will recommend that there should be a deemed disposition of the property when such changes in use occur.

Application of Rules to Particular Expenditures. We now refer briefly to the application of these rules to expenditures related to employment, to the holding of property and to business. Detailed discussion is contained in the chapters concerned with the major sources of income.

1. We have suggested that there should be a more liberal approach than currently exists to employee expense deductions. We believe that the best way to achieve an equitable treatment of expenses related to employment is generally to apply the same rules to these expenditures as are to be applied to business expenditures. Thus, the present prohibition on the deduction of most employment expenses should be withdrawn, and the three rules outlined above should apply. To reduce the administrative problems of accounting for many small expenditures, we suggest the use of an optional standard deduction of 3 per cent of employment income, with a maximum deduction of $500, in respect of the expenses of earning such income; but we also recommend that the employee should be entitled to substantiate a larger deduction if he can do so. However, there are some expenditures, of which commuting expense is an example, which have some relation to employment but which have been, and in our view should continue to be, disallowed as being more of a personal nature. Therefore, it will be necessary for greater certainty to have specific provisions in the legislation disallowing a number of expenditures that might otherwise be deductible under the general rules.

2. It seems apparent that the average individual acquires much of his property, for example, household furnishings and equipment, for personal use or consumption and not for the purpose of deriving income. Expenditures required to carry and maintain such property should not be deductible. There will, however, be cases where property is acquired partly in anticipation of earning income and partly for personal use. An obvious example is the purchase of a home a portion of which is rented. Here the part of the expense of carrying and maintaining the property which represents an expenditure of a personal nature should not be deductible in computing the income from the holding of the property.

An asset that a taxpayer holds, whether or not it is acquired for personal use or consumption, may be disposed of at a gain. Under the comprehensive tax base such a gain would be taxable (unless it comes within the lifetime exemption for gains on residential and farming property). However, a taxpayer may incur deductible expenditures related to the holding of property which exceed the annual income therefrom and so produce an annual operating loss, although the property is eventually disposed of for an amount exceeding the total costs. For this reason, we later recommend that a taxpayer should be allowed to elect to add certain deductible expenditures related to the holding of property to his cost basis of such properties, rather than to treat them as operating items. Where, however, the property is held for personal use, we do not consider that he should be entitled either to deduct the expenses from operating income or to add them to the cost basis.

3. Problems may also arise for a business with respect to expenditures of a personal nature. The general rules we have discussed would serve to prevent the deduction of most of these expenditures. There are, however, expenditures (other than normal remuneration) that are a reasonable cost of doing business but also confer a benefit on an employee, supplier, customer, proprietor, partner, shareholder or member. In later chapters we make specific suggestions for the taxation of these benefits, either in the hands of the recipient or the provider.

Capital Outlays. We have discussed some of the existing restrictions on deductions from income and have indicated that there are now restrictions on the deduction of outlays of capital 43/. Our basic approach is that all expenditures reasonably related to the production of income should be deductible, subject to the other statutory rules. A restriction on outlays of a capital nature would be incompatible with that approach, although the timing of the deduction of expenditures would remain important.

Exempt Income. The present legislation also disallows expenditures made to produce exempt income 44/. Under the comprehensive tax base, virtually all gains would be subject to tax. We therefore do not believe that such a provision would continue to be necessary.

Provisions in the Legislation for Specific Deductions. There remains the question of the extent to which the legislation should provide for specific deductions in computing income. Under our proposals most expenditures reasonably related to the production of income would be deductible at some time. We anticipate that a significant number of the detailed provisions in the Act relating to specific deductions 45/ would cease to be required. However, some provisions for specific deductions would continue to be necessary because some types of expenditures are not related to the earning of income, as in the case of alimony and maintenance payments. With respect to certain expenditures, the legislation should continue specifically to limit the amounts which are deductible for tax purposes, as in the case of charitable donations and contributions to registered retirement income plans.

Timing of Deductions. All deductible expenditures should be deductible currently except for the three following specified classes of expenditure which will provide benefits for periods extending beyond the taxation year:

1. Expenditures for the acquisition of business inventories, to which we refer below.

2. Expenditures for the acquisition of the long-term assets specified in capital cost allowance schedules which would become deductible through the claiming of capital cost allowances. Most of the so-called "nothings" would be currently deductible or would fall within one of the present or new capital cost allowance classes.

3. Expenditures to acquire securities, land, goodwill, trade marks and other assets of indefinite life. We think that any deduction in respect of such expenditures should be permitted only on disposition of the asset or upon a proven loss in value.

We recommend that the provisions of the Act and the Regulations with regard to inventory valuation should be repealed, and that inventories should be valued in accordance with recognized accounting practices. However, we later suggest certain limits on the extent to which the last-in-first-out method of inventory valuation may be utilized.

The principles applicable to the determination of business income should also be applicable, in appropriate cases, in computing income from other sources. Thus, we think that the capital cost allowance system should apply in determining income from the holding of property, and that a reasonable provision for bad debts should be permitted in connection with the sale of an asset on credit.

General Treatment of Losses. A taxpayer may sustain losses rather than make gains from carrying on an activity which he anticipates will be productive of income. Losses usually result from the holding or disposition of property or from carrying on a business. We have seen that losses of a capital nature, whether they arise from the disposition of property or not, are not at present deductible in computing income.

Under our proposals, gains of all types would be brought into the tax base. These would include gains from carrying on business, gains from the disposition of property and other gains which have heretofore been treated as being of a capital nature. There would be losses corresponding to each of these types of gains, for example, losses sustained in holding or disposing of property, or losses sustained in carrying on a business.

Under the present system, income is treated as an aggregate concept, and it is possible, in computing income for the year, to deduct from the income realized from certain sources, losses of an income nature realized from other sources. The one exception is the provision which limits the amount of the loss from hobby farming which may be deducted from other income 46/. In addition, subject to certain restrictions, business losses

of one year may be carried back against business income of the previous year and forward against business income of the following five years 47/.

Our general approach is that all losses, other than those of a personal nature, should be deductible for tax purposes from any income and that there should be liberal rules relating to the carry-over of such losses.

We now turn to an outline of our proposal which includes certain limitations intended to prevent the deduction of items that are largely of a personal consumption nature.

Losses from Holding Property. The holding of property during a particular year may result in an excess of operating expenditure over operating income. Where the property is held for personal use or consumption, such expenditure should, as we have said, be disallowed. Therefore, the question of an operating loss on such property for tax purposes should not arise. However, operating losses will occur in other cases; for example, where land or a security is held in whole or part for purposes other than personal use or consumption. Because a taxpayer is not required to bring unrealized property gains into income, we do not consider that he should be entitled to deduct a loss from the holding of property from other income for the year. However, in order to obtain a matching of income and expense while limiting the deduction of personal expenditures, the taxpayer should ordinarily be entitled to two alternative types of relief in respect of such an operating loss:

1. To carry such a loss forward against operating income from the holding of the same property for an indefinite period.

2. Because some of the annual expenditures might be related to the gain which might ultimately be realized on the disposition of the property, to elect to add the amount of certain expenditures to the cost basis of the property,

rather than to treat them as operating expenses to be deducted in the computation of the annual income. As we explain in Chapter 15, such amounts would be specified and might include interest costs, expenses incurred in preserving title to the property, the amount of any damages for which the taxpayer became responsible as the holder of the property, and property taxes. It is not intended that this election would be employed as a means of deducting personal expenditures, so the interest and property taxes applicable to a residence and the adjacent land should not be deductible under this election. The general prohibition against the deduction of personal expenditures should accomplish this. Under this second type of relief, the taxpayer would be able to reduce or eliminate an operating loss which he might not have been able to deduct from subsequent income from the holding of the property prior to disposition, and his gain or loss on the ultimate disposition of the asset would be affected by the increase in the cost basis.

Losses on Disposition of Property. Because we contemplate that all gains on the disposition of property, except limited gains on certain residential, including farm, properties, should be taxable, equity requires that all losses on such dispositions should be deductible in computing income. With minor limitations to preclude the deduction of items of personal expenditure, we recommend that such deductibility be permitted.

In substance, our approach is that a loss on the disposition of a property should be deductible if the property is of such a kind that expenditure on its acquisition would be deductible at some time under the general statutory rules we have proposed. The principal effect of this approach would be to deny deductibility to losses on property held for personal use or consumption. We are convinced that such a denial is essential. Moreover, we would expressly deny a deduction for losses on the disposition of real property used by the taxpayer as a residence, even though the general rule would partially cover this, to match the exclusion already mentioned for gains on such property.

We recommend that losses on the disposition of property, which are not disallowed under a specific provision, should be deductible from income of all kinds in the year of loss and that it should be possible to carry them back two years and forward indefinitely against income of all kinds. This treatment is the same as that suggested below for business losses.

For losses on the disposition of property that would not be deductible, because the property had been employed in personal use, we suggest another type of relief. It seems to us that a loss on the disposition of property of a particular class, such as works of art, should be deductible from gains on the disposition of other properties of the same class in the year of loss, in the previous two years, or in the following six years. The classification of such properties might be established by regulation in order to provide a degree of certainty in this area.

We deal at some length in Chapter 15 with the treatment of losses on the disposition of property and suggest an alternative approach to the problem in the event that the treatment recommended above is regarded as too generous or proves difficult to administer.

Business Losses. We have already mentioned that, under the present system, an operating loss of a business ordinarily may be applied against income of other kinds in the year in which it is sustained and may also, subject to certain restrictions, be carried back against business income of the previous year and be carried forward against business income of the following five years. We think that such losses should continue to be applicable against income from all other sources in the year of loss, but that the present loss carry-over provisions should be liberalized. It should be possible to carry business losses back two years and forward indefinitely. It should also be possible to apply all deductible business losses against income from all sources, rather than simply against business income during the carry-over period. The requirement that a loss is deductible only to the extent that it was not deductible in a prior year should be retained.

However, there is one limitation which we think should be imposed on this liberal treatment of business losses to ensure that expenditures that are mainly of a personal consumption nature are not deducted from other income. Although the proposed general rules should be effective, they are difficult to apply to a business operation that is maintained despite persistent losses because the owner is obtaining a non-monetary personal benefit from the operation. The so-called "hobby farm" is one example of such an operation, although loss activities for personal satisfaction are by no means limited to farming. The suggested limitation would apply where a particular business sustains net losses over a lengthy period. It does not seem reasonable to us that it should be possible to apply such losses against gains from other businesses or against other income of the taxpayer. We realize that difficulties may arise in determining whether one or more businesses are being carried on by a particular taxpayer and in segregating businesses in such cases, but we do not think such difficulties are insurmountable 48/.

We appreciate that it is necessary, in considering a limitation of this kind, to take into account the special position of a new business. It will frequently take such a business a number of years to establish itself. We also appreciate that it is necessary to consider the position of an established business which encounters new conditions and as a result incurs consistent losses.

We propose that losses of a business (whether or not it is a new business) should be deductible from income from all sources in the year of loss, in the two preceding years and in future years, unless and until losses have been sustained in three years which fall within a five-year period. However, if losses have been incurred in three such years, any further loss incurred following the third such loss year should not be deductible from any income of the taxpayer, either in the year of loss or any other year, from sources other than the loss business. Such subsequent

losses could be carried back two years and forward indefinitely and applied against income of the same business. If, after sustaining such losses, the business then becomes profitable, and the profits realized in the years subsequent to the loss years exceed all losses from the same business deducted in previous years (including the losses deducted from other income), such business would again become eligible to claim an unlimited write-off of losses against other income unless and until the three-year rule again becomes operative.

The limitations which we have suggested should prevent the erosion of tax revenue by the continued application against gains from other sources, of losses sustained by businesses that are carried on with no reasonable expectation of profit. We think the limitation we have suggested, in conjunction with the direct disallowance of personal expenditures, should substantially eliminate the hobby farm problem so that there would be no need for continuation of the present provision of the Act on that subject 49/. In addition, we think that a completely general provision of this nature has merit in that it should be capable of useful application in many areas other than that of farming as now defined 50/.

It should be noted that in computing a loss a taxpayer need not claim capital cost allowance, and therefore a limitation of this nature should usually be of little concern to a genuine business operation. In addition, we later recommend that certain specific expenditures such as property taxes and interest, should, on election, be capitalized rather than be included in operating expenses. Again this would reduce the possibilities of a loss being sustained in a genuine business operation.

It might also be provided that any losses sustained subsequent to the three years would be deductible from all other income if the business had an overall profit, that is, if the profits exceeded the losses, during a period of, say, seven years beginning with the year of loss. A provision of this nature would permit, for some businesses, the deduction of a loss

from other income in the year of loss, rather than requiring it to be carried forward for deduction from income of the same business.

It is not our intent that our proposals should inequitably worsen the position of the bona fide farmer who needs to take off-farm employment to assist in maintaining and expanding his farm. If it is felt that our proposals would deter such farmers from taking off-farm employment, consideration should be given to a modification of the loss limitation to provide additional relief in this case.

We also recommend later that the legislation should continue to restrict the transferability of losses, although the introduction of the comprehensive tax base, and the liberal loss carry-over provisions would mean that most losses would be deductible at some time.

Other Losses. In the event that losses arise which are not from the holding or disposition of property or from the carrying on of business, it seems to us that they should be allowed, assuming they have been computed in accordance with the general rules for computing income. Here again we think it should be possible to apply the losses against any other income in the year of loss and to carry them back two years and forward indefinitely against all income.

Summary of Proposed Treatment of Deductions. It is therefore our view that the introduction of our comprehensive tax base would greatly improve taxpayer equity by allowing the deductions of all expenditures involved in earning income. Thus, the category of "nothings" would be eliminated from legitimate business expenditures.

In addition, all expenditures laid out to earn income would be similarly deductible, regardless of the type of income involved. In this connection, we recommend the removal of the limitation on the deduction of expenses related to employment income.

We have pointed out, however. that expenditures of a personal consumption nature should not be allowed to reduce the comprehensive tax base. We are very conscious of the difficulty of determining when an expenditure is in fact of a personal nature. It is obviously necessary for overall taxpayer equity to ensure that this aspect of the comprehensive tax base does not become the subject of widespread taxpayer abuse. It is also important that any uncertainty as to the meaning of the tax legislation should be reduced to a minimum. We have therefore proposed that the existing statutory provisions prohibiting the deduction of personal or living expenses should be retained and that it should be left to the courts to continue to establish general principles of what is, and is not, deductible. However, to reduce the uncertainty in borderline areas, we propose that the legislation should also specifically define certain expenditures to be of a personal nature. We appreciate that many taxpayers will feel that the arbitrary nature of the latter rules and the proposed limits are unduly restrictive. However, we feel this is an area where the limits must not be liberal.

On the other hand, we recommend that a liberal approach be taken as to the timing of properly deductible expenditures. Although we do not recommend that all income should be taken into account as soon as it arises, we do suggest that, in general, expenditures should be deductible as soon as incurred, even if they provide substantial benefits for future periods. Although this severely twists the concept of matching income and expenses, to the substantial benefit of the taxpayer, we feel that such liberality would minimize the inequities that would arise if the general principles were applied rigorously, would reduce the uncertainty that could arise if many items had to be allocated in some fashion over a number of time periods, and would provide some economic benefit in permitting the immediate write-off of expenditures such as research, staff training and product development, that have some longer run value.

Thus, not only should all the costs of obtaining income be deductible but most of them should be deductible when incurred. This liberal approach

should also be carried over into the treatment of losses to ensure that when the expenditures on one endeavour exceed the revenue therefrom, the taxpayer would be able to offset such losses against other income as rapidly as possible. Similarly, the approach that all income-producing expenditures should be deductible at some time should be carried over to permit the allowance of all losses (other than those of a personal nature) at some time.

It should also be noted that our recommendations have been designed to treat all income in a similar fashion, regardless of its source. Thus, the current importance of the differentiation between business and investment income would disappear. Whether a property or business yields a gain or a loss, and whether the gain or loss is of an operating nature or arises from the disposition of an asset, the tax position would be the same. Thus, where we have suggested limitations, such as on the deductibility of some expenditures and on the allowance of some losses, we recommend that they apply in a similar fashion to both kinds of income. As a result, we would expect that much of the uncertainty and litigation arising under the present system, because of the attempt to differentiate between sources of income, would disappear.

CLASSES OF TAXPAYERS

Individuals and Families

Under the present legislation the individual is the tax unit for purposes of personal income tax. We propose that a husband and wife and their dependent children should constitute a tax unit. This would ordinarily involve the aggregation of their incomes in a joint return and the income of the family unit would be taxed according to a particular rate schedule applicable to such units. There would be tax advantages, which are referred to in Chapter 11, to membership in a family unit. An individual who was not a member of a family unit would constitute a separate tax unit and be taxed on a separate rate schedule.

Sole Proprietorships, Partnerships and Syndicates

Where an individual carries on business as a sole proprietor, the income of the business is now treated as his income. Partnerships and syndicates are not treated as separate taxpayers, and, under the Act, partners and members of syndicates must include in personal income their share of partnership income for the year whether or not they withdraw it 51/. We propose that these treatments be continued.

Intermediaries

Speaking generally, under the present system, corporations are treated as separate tax-paying entities and are taxed on their corporate income; when they distribute their after-tax income to the shareholders, the latter bring the amounts distributed into income. Under our proposals, the corporation would be taxed on its income, but the rules with regard to distribution from such taxed income to resident shareholders would be materially changed. In effect, resident shareholders would be taxed on their portions of the pre-tax corporate income that the distribution or allocation represents, and they would receive full credit against their own tax for the corporate tax paid on such income. The effect of this proposal would be that the treatment accorded to corporate income would be similar in principle to that applied to individual proprietors or partners.

Our approach to the tax treatment of corporate income brings the taxation of the ordinary corporation and its shareholders much closer to the present taxation of the co-operative and its members or patrons. We later suggest changes in the taxation of co-operatives which would bring the taxation of corporate and co-operative income flows even more closely into line. We also suggest changes in the taxation rules applicable to other mutual organizations such as credit unions, caisses populaires and mutual insurance companies, and to charitable organizations, private clubs and non-profit organizations.

Under the Act, trusts and estates are treated as individuals for tax purposes, and special rules apply to the taxation of the income therefrom 52/. We will make recommendations under which the taxes imposed upon them would be integrated with the tax liabilities of resident beneficiaries, in much the same way as is recommended in the case of other intermediaries. We have already mentioned that we recommend treating gifts and inheritances as income of the recipient for tax purposes and abolishing the present gift and estate taxes.

We believe that the taxation of intermediaries, such as corporations, co-operatives and trusts, should be integrated so far as possible with the taxation of the individual shareholders, members, or beneficiaries who hold residual claims against these entities. Our specific proposals are designed to reduce opportunities for tax avoidance and to remove any discrimination against income passing through such intermediaries.

Residence

In this chapter, we have noted the differing tax treatment of residents and non-residents of Canada under the present law. Under our proposals this basic distinction would remain. However, residence would be of added importance with regard to income from intermediaries since, in general, only the taxation of resident individuals would be integrated with the taxation of intermediaries.

THE DETERMINATION OF TAX

Under the present Act, once net income, the aggregation of all gains and losses, has been ascertained, certain amounts are deductible therefrom in computing taxable income 53/. For an individual, they include amounts based upon his single or marital status, the number and age of his dependants, and his medical expenses. For taxpayers generally, they include charitable donations and gifts to the Crown. In the case of resident corporations, they also include, subject to certain restrictions, dividends from other

resident corporations and dividends from other corporations of specified types in which the recipient has a particular share interest 54/. We recommend a number of alterations in this treatment.

Our general approach to the treatment of non-discretionary expenditures of individuals, and to the granting of certain concessionary allowances, has already been discussed. We have suggested that the present system of deductions from the income of individuals, which depends on their personal status and dependants, should be replaced by a system of credits against tax, and that credits should also be granted to working mothers with school age children, and in respect of certain expenditures on post-secondary education. However, we recommend that the present general approach of permitting deductions in respect of certain medical and related expenses and charitable donations should be continued.

The Rate Schedules

The tax now imposed on the taxable income of individuals is calculated from a rate schedule in the Act under which the initial rate is 11 per cent and the top marginal rate is 80 per cent 55/. In Chapter 11 we propose that there should be two rate schedules for personal taxation. One of these would be applicable to family units and the other to individuals not in a family unit. The top marginal rate in each schedule should be 50 per cent.

Under the Act there is a dual rate of tax on corporate income 56/. We recommend that this dual rate of tax be replaced by a single rate of tax equal to the proposed top marginal personal rate of 50 per cent. To compensate for this change, particular types of concessions for new and small businesses, both corporate and otherwise, are proposed in Chapter 22.

Deductions from Tax

The Act permits certain deductions to be made from the tax otherwise payable by individuals and corporations. The basic deductions are summarized below.

Provincial Abatements. The provinces of Canada all impose taxes on the income of individuals and corporations. Under the Act, deductions from tax are allowed both to individuals 57/ and to corporations 58/ in respect of income earned in the year in a province. These deductions are referred to in Chapter 38, where we emphasize the importance we attach to harmonizing the federal and provincial tax systems in the future.

Dividend Tax Credit. Individuals who are resident in Canada are presently entitled to deduct from tax 20 per cent of the net dividend income received from taxable Canadian corporations 59/. This dividend tax credit was designed to mitigate the effect of taxing corporate income both to the corporation and, on distribution. to the shareholder. Under our proposals for the taxation of corporate income, this provision would no longer be required, because resident shareholders would receive full credit for the corporate tax paid on income distributed.

Foreign Tax Credit. Residents of Canada are taxed under the Act on income from sources outside as well as from inside Canada, but they are entitled to credits against the Canadian tax on such income in respect of the foreign taxes they pay on foreign source income 60/. These credits and our proposals with respect to the treatment of foreign source income are dealt with in Chapter 26.

Provincial Mining and Logging Taxes. The Act contains a provision for a deduction from tax in respect of provincial logging taxes 61/. It also provides for a deduction in respect of provincial mining taxes 62/. However, the latter is not a deduction from tax but a deduction in computing income. We recommend in Chapters 23 and 25 that all such taxes be allowed in the future as deductions in computing income.

Credits Against Tax Generally. The present deductions from tax mentioned above relate, with the exception of the dividend tax credit, to taxes paid to other governments whether provincial or foreign. Under our proposals

this kind of deduction from tax would continue, but there would be two other basic types of credits against tax. The first is exemplified by the credit that would be available by virtue of family status; here there would have been no prior payment to another government. The second arises when the taxpayer receives credit in respect of a tax paid by someone else. This type of credit may arise, for example, when the taxpayer receives a distribution from an intermediary such as a corporation, co-operative or trust.

Concessions to Certain Industries and Special Types of Corporations

As the present system has developed, special rules have become applicable to the taxation of particular industries, particular types of taxpayer, and particular types of income. We have considered these special cases critically and in many instances suggest modification of the present rules. We discuss, for example, the taxation of the mining and petroleum industries, certain financial institutions, farming, fishing, forestry, the construction industry and general insurance. In each of these cases we propose alterations to the present treatment. We also indicate that the present tax treatment of personal corporations and diversified investment companies would have no place under our proposals. In addition, we consider that the preferential treatment of non-resident-owned investment corporations and foreign business corporations should be withdrawn over a period of time.

Averaging

The Act now provides for relief in isolated cases from the tax impact which results under the progressive rates from the receipt of unusual types or amounts of income in a particular year. Receipts of this kind would become more frequent under the comprehensive tax base, which includes in income such gains as gifts and bequests, gains on the disposition of property, and windfalls. In Chapter 13, we consider the problem of irregular or fluctuating income and we make comprehensive proposals for averaging the income of individuals.

TAX AVOIDANCE

The propensity of taxpayers to avoid tax probably tends to follow tax rates, and with the rates of tax as high as they are today, the temptation is strong. Tax avoidance probably came into its own during World War II and in the postwar period when the rates were sufficiently high to make the tax saving outweigh the expense and inconvenience of tax avoidance measures. A large number of ingenious devices have been invented and perfected to enable the well-advised taxpayer to pay less than he otherwise would. Indeed, tax avoidance has been described as "hydra-headed", for as one escape contrivance is discovered and cut off by Parliament, the taxpayer raises another. This process has been aided considerably by the anomalies and inconsistencies in the present tax system.

It is probably true that the present heavy incidence of income tax is bringing more and more Canadian businessmen to plan their affairs to minimize their tax liability. The complaint is often made that the high tax rate structure is designed in such a way that it discourages expansion, economic progress, individualism, and the intelligent use and increase of capital by risk taking. In practical terms, if the businessman can minimize his taxes he will have generated funds which he may use for expansion and so be able to compete more effectively. As a result many taxpayers resort to every stratagem open to them under the law to keep their taxes at a minimum.

There is a striking difference in the approach of the courts in the United States of America toward tax avoidance, and the approach taken by the courts in Canada and in the United Kingdom. It is our view that the taxing statute should be interpreted by the courts fairly and equitably and in such a way as to give effect to the legislative scheme, without any presumption being made either for or against the taxpayer. In our view the courts should also have regard to the true nature and effect of transactions and take into account their economic substance as well as their legal effect. We discuss this question further in Chapter 32.

The Act now contains a number of provisions which are designed to prevent tax avoidance. Some of these relate to specific circumstances, while some are very general in their application. Other provisions apply to transactions between persons related in certain defined ways who are deemed not to deal with each other at arm's length.

In Appendix A to this Volume we discuss the various approaches to the problem of dealing with tax avoidance. We believe that our basic proposals concerning the tax system would eliminate many inconsistencies and reduce the areas in which tax avoidance would be feasible or attractive. There would, of course, still be possibilities for avoidance or reduction of tax, particularly in transactions between residents and non-residents.

We indicate our views in Appendix A as to the kinds of anti-tax avoidance provisions which in our opinion would be effective and equitable. We also state there a number of conclusions which include the following:

1. Tax avoidance provisions should normally be expressed in sufficiently general terms that the courts will be able to interpret the words in the context of the legislative scheme and apply them according to the merits of the particular case. However, they should not be so broad and general that they have no clear meaning.

2. The irrebuttable presumption that certain related persons are not dealing with each other at arm's length should be made rebuttable in the case of relationships between brothers, sisters, brothers-in-law and sisters-in-law, but should remain irrebuttable as between spouses, parents and their children, and corporations subject to common control.

3. Transactions between persons not dealing with each other at arm's length should be adjusted to reflect fair market values or to satisfy a test of reasonableness. Such adjustments should be applied to the tax accounts of both parties and for all purposes of the legislation. However, these provisions would not be applicable in the case of transactions designated as tax-free reorganizations or transfers.

4. Discretionary powers should be granted only in extreme circumstances and then ordinarily as a temporary measure. There should not be a general tax avoidance provision such as section 138 of the Income Tax Act.

The foregoing is a brief outline of the more important changes in the present tax system which we will recommend. Our specific recommendations are outlined in detail in the chapters which follow.

CONCLUSIONS AND RECOMMENDATIONS

1. The tax base should be defined in the statute to include the value of net gains of all kinds realized during the year.

2. All of the kinds of income presently taxed would continue to be taxed under the system we propose, although in some cases the basis of taxation would be changed.

AMOUNTS INCLUDED IN THE TAX BASE

3. Gains on the disposition of property should be taxed like other income with the exception of a $25,000 lifetime exemption for gains on the sale of certain residential, including farm, properties.

4. Gains which are now treated as being of a capital nature, or which may be so treated depending on the circumstances, such as the proceeds on the sale of a business, compensation for loss of an office or employment, forgiveness of debt, lease premiums, loan premiums and discounts, amounts received on breach or cancellation of contracts, proceeds of insurance policies other than life insurance, profits on foreign exchange, damage payments, government subsidy payments and proceeds of expropriation of property, should all be brought into the tax base.

5. With certain exceptions, gifts and inheritances should be subject to tax like other income, while the present gift and estate taxes should be abolished.

6. Windfall gains should be included in the comprehensive tax base.

7. Generally speaking, there should be no exclusions from the tax base other than those already mentioned. Mortality gains and losses on Canadian life insurance policies incurred by the tax unit that paid the premiums would be excluded at the outset but the net proceeds after deduction of premiums and investment income which had been taxed should be included in the tax base at a later stage.

METHODS OF COMPUTING INCOME

8. The following treatment is recommended:

   a) With a few specific exceptions employment income should be taxed when received.

   b) Income from a business should be taxed on an annual accrual basis except in the case of farming or professional income of certain taxpayers with low revenues.

   c) Gains on the disposition of property should be taxed when realized or deemed to be realized.

   d) Income from holding property could be taxed on either basis, but with specific provisions requiring some items to be taxed when set aside for the taxpayer.

   e) Other types of income should in general be taxed when received.

APPLICATION OF ACCOUNTING PRACTICES

9. As at present, the profit from a business or property should be determined in a manner consistent with generally accepted accounting practices except where otherwise provided in the statute; but no specific reference to accounting practices should appear in the Act. However, fewer statutory rules should apply to the determination of such income, so that accounting practices would play a larger role in this area.

GENERAL APPROACH TO DEDUCTIONS

10. Consistent with our approach that all gains should be brought into the tax base, all expenditures reasonably related to producing those gains should be deductible.

THE RULES OF DEDUCTIBILITY

11. The Act should contain three general rules governing the deductibility of expenditures.

Rule 1. Expenditures "reasonably related" to the gaining or producing of income should be deductible. This rule has positive and negative aspects. It would prohibit the deduction of:

a) expenditures of a personal nature; and

b) gifts.

It would permit the deduction of any expenditures made with a reasonable expectation of profit or made as an incident of earning income.

Rule 2. Expenditures should only be deductible to the extent to which they are reasonable in the circumstances. This rule is primarily concerned with the amount of an expenditure.

Rule 3. To reinforce the above rules, expenditures of a personal nature should be explicitly denied deductibility.

In addition to these general rules, some deductions should be specifically denied in the Act, for example, commuting expenses, and expenses of carrying or maintaining property for personal use or consumption.

CAPITAL OUTLAYS AND OUTLAYS TO GENERATE EXEMPT INCOME

12. There should be no restrictions on the deduction of capital expenses except for questions of timing. Since virtually all income would be taxable under the comprehensive tax base, there would be no need to prohibit the deduction of expenses incurred to earn exempt income.

SPECIFIC DEDUCTIONS PROVIDED
IN THE LEGISLATION

13. Most of these provisions in the Act could be deleted, but some exceptions would remain for expenditures unrelated to the generation of net gains, such as alimony and maintenance payments, charitable donations, and contributions to registered retirement income plans.

TIMING OF DEDUCTIONS

14. Current deductibility should be permitted except where explicitly denied. The exceptions would be expenditures on the acquisition of:

   a) business inventories;

   b) long-term assets specified in capital cost allowance schedules;

   c) securities, land, purchased goodwill, trade marks and other assets of indefinite life; these costs would be deductible on disposal of the asset or on a proven loss in value.

15. Business inventories should be valued in accordance with recognized accounting practices but with specific limits on the use of the last-in-first-out inventory valuation method.

16. No general prohibition on the deduction of amounts transferred to reserves is necessary.

17. All reasonable provisions for bad debts should be allowed with specific statutory provisions in certain cases.

LOSSES GENERALLY

18. In principle, all losses should be deductible in computing income for tax purposes, with liberal rules relating to the carry-over of losses.

LOSSES ON HOLDING PROPERTY

19. Losses from the holding of property, other than property held for personal use, should be:

a) carried forward against operating income from the same property for an indefinite period; or

b) reduced by the amount of certain expenditures related to the property which would be added to the cost basis of the property.

LOSSES ON DISPOSITION OF PROPERTY

20. The deduction of losses from other income on the disposition of property held for personal use should be denied. However, most of such property losses (the exception being certain residential property which we recommend be excluded from income) should be deductible from gains on the dispositions of other properties in the same class in the year of loss, in the previous two years, or the following six years.

21. Losses on the disposition of other property should be deductible from income of all kinds in the year of loss, and it should be possible to carry such losses back two years and forward indefinitely against all kinds of income.

BUSINESS LOSSES

22. Generally, the tax treatment of business losses should be the same as for losses on the disposition of property not held for personal use. To prevent the deduction of personal expenditures certain limitations are necessary. A business with persistent losses should not be allowed to deduct such losses except against gains from the same business. Thus, if a business produces losses for three years within a five-year period, the taxpayer should not be allowed to apply subsequent losses against income from sources other than the same business, until such income derived from the business has exceeded all losses claimed earlier, including the losses deducted from other income. The losses of the first three years would be deductible from all income.

CLASSES OF TAXPAYERS

23. Both families and unattached individuals should be treated as tax-paying units. Members of families would be entitled, with certain restrictions, to elect to be taxed as separate individuals.

24. The present treatment of sole proprietorships, partners and syndicates should remain unchanged.

25. Intermediaries, such as corporations, trusts and mutual organizations, should be taxable, with full credit for such tax being given to resident shareholders, beneficiaries, and members on the distribution or allocation of the income of the intermediary to these residual claimants.

RESIDENCE

26. Distinctions between the tax treatment of residents and non-residents would remain.

DETERMINATION OF TAX

27. The present system of deductions for personal status and dependants should be replaced by a system of credits against tax; credits should also be given to working mothers and in respect of certain expenses on post-secondary education.

28. Deductions from income should be permitted for medical expenses over certain limits and for charitable donations with certain qualifications.

29. There should be two personal rate schedules: one for families and one for individuals.

30. Full credit for taxes paid by intermediaries should be allowed to the beneficiary of a distribution or allocation. Therefore, the dividend tax credit should be withdrawn, the dual corporate rate should be abolished and a flat rate of corporate tax equal to the top personal

rate of 50 per cent should be established. New and small businesses should be granted certain concessions.

31. Mining and logging taxes should be allowed only as deductions in computing income.

32. Foreign tax credits should be allowed under most circumstances.

TAX AVOIDANCE

33. Tax avoidance provisions should normally be expressed in general terms but should not be so broad and general that they have no clear meaning.

34. The irrebuttable presumption that certain related persons are not dealing with each other at arm's length should be made rebuttable in the case of relationships between brothers, sisters, brothers-in-law and sisters-in-law but should remain irrebuttable as between spouses, parents and their children, and corporations subject to common control.

35. Transactions between persons not dealing with each other at arm's length should be adjusted to reflect fair market values or to satisfy a test of reasonableness for both parties except in transactions designated as tax-free reorganizations or transfers.

36. Discretionary powers should be granted only in extreme circumstances and then ordinarily as a temporary measure. There should not be a general tax avoidance provision such as section 138 of the *Income Tax Act*.

REFERENCES

1/ Section 2.

2/ Section 3.

3/ Section 4.

4/ The court decisions refer variously to commercial and accounting principles and practices and similar terms, but in this Report for purposes of convenience we adopt the phrase "recognized accounting practices" as covering this general area and treat the phrase as including the principles underlying the practices.

5/ A leading decision to the effect that accounting practices are not necessarily determinative of income for tax purposes is M.N.R. v. Anaconda American Brass Ltd., [1956] A.C. 85, where the Judicial Committee of the Privy Council refused to recognize the last-in-first-out method of inventory valuation as acceptable for tax purposes.

6/ Section 5.

7/ Examples are dividends, pension benefits, interest, alimony and maintenance payments in certain events, benefits of an income nature from estates or trusts, and amounts dependent on the use of or production from, property. These examples are taken from section 6 of the Act.

8/ For example, sections 6(1)(p), 19A, 25, 85B, 85D and 85E.

9/ Section 10.

10/ Section 3 which treated as income various items "and also the annual profit or gain from any other source".

11/ Section 6(1)(a)(v) and the definition of "retiring allowance" in section 139(1)(aj).

12/ The treatment of cancellation of indebtedness is discussed in Chapter 18.

13/ Until recently, the final court of appeal in Canadian cases was the Judicial Committee of the Privy Council in the United Kingdom, and its decisions in such cases were binding here.

14/ Case VI of Schedule D.

15/ Royal Commission on the Taxation of Profits and Income, Final Report, Cmd. 9474, London: H.M.S.O., 1955, paragraphs 30 and 31.

16/ Harvard Law School, International Program in Taxation, Taxation in the United States, World Tax Series, Boston: Little, Brown and Company, 1963, p. 367.

17/ Section 10. Also, under section 62(1)(a), the taxable income of certain employees of foreign governments serving in Canada is exempt from tax, subject to certain conditions.

18/ See section 5.

19/ The specific examples given and a number of others are to be found in section 6.

20/ Section 6(1)(b).

21/ In Chapter 22 we will refer to the treatment of instalment sales, and, in the part of Chapter 25 dealing with the construction industry, we will discuss certain aspects of the determination of profits in that industry.

22/ Section 85F.

23/ Section 4.

24/ Section 12(1)(e).

25/ Section 11(1)(e) and (f).

26/ Section 85B.

27/ Section 5(1), but note also section 5(2).

28/ Section 4.

29/ Section 12(1)(a).

30/ Section 6(1)(a).

31/ See, for example, Royal Trust Company v. M.N.R., 57 DTC 1055.

32/ Steer v. M.N.R., [1965] Ex. C.R. 458, a case which is under appeal to the Supreme Court of Canada.

33/ Section 12(1)(b).

34/ Section 11(1)(a) of the Act and a number of regulations. The question of capital cost allowances is referred to later in this chapter and is discussed in Chapter 22.

35/ Section 12(1)(c); the term "exempt income" is defined in section 139(1)(o).

36/ See section 28 and the definition of exempt income in section 139(1)(o).

37/ Section 12(1)(h); the term "personal or living expenses" is given an extended meaning in section 139(1)(ae).

38/ Section 12(2).

39/ Section 137(1).

40/ Sections 12(1)(a), (b) and (h) referred to above.

41/ Section 12(2).

42/ Section 12(1)(h).

43/ Section 12(1)(b).

44/ Section 12(1)(c).

45/ Such as some of those contained in section 11.

46/ Section 13.

47/ Section 27(1)(e).

48/ See section 139(1a) of the Act and the discussion in Chapter 22.

49/ Section 13.

50/ The definition of "farming" is contained in section 139(1)(p).

51/ Section 6(1)(c).

52/ Section 63.

53/ See section 2.

54/ The deductions from income in computing taxable income are set out in sections 26 to 31A.

55/ See section 32 which should be read with section 33(4). Under section 32, there is provision for a 4 per cent surtax on investment income from sources outside Canada; we recommend in Chapter 15 that this surtax be abolished. Apart from the tax under the normal rate schedule, a tax of 4 per cent of taxable income with a limit of $120 is imposed under the Old Age Security Act; we recommend in Chapter 18 that the separate taxes imposed by that Act be discontinued and be merged into the ordinary rates.

56/ Under section 39, the rate of tax is 18 per cent on the first $35,000 of taxable income and 47 per cent on the excess. An additional tax

of 3 per cent of taxable income is imposed under the Old Age Security Act; we recommend in Chapter 18 that the separate taxes imposed by that Act be discontinued and be merged into the ordinary rates.

57/ See section 33.

58/ See section 40.

59/ See section 38.

60/ See section 41.

61/ See section 41A and section 700 of the Regulations.

62/ See section 11(1)(p) and section 701 of the Regulations.

CHAPTER 10

THE TAX UNIT

Throughout the history of Canadian federal personal income tax, the tax unit has been the individual. By this we mean that tax liability falls on the person receiving the income, whether that person be single, married, a child, or of any other status, and it is calculated primarily in relation to the amount of income earned by that individual. There is no general rule for the aggregation of incomes of members of an economic or social unit, such as the family. The closest approach to recognition of the fact that the incomes of closely connected persons may have some interrelationship is in the adjustment of certain of the general deductions where a statutory dependant has income. Thus, the deduction of $1,000 which is, in effect, given to a man who supports his wife, is reduced by the amount of her income in excess of $250 and is therefore eliminated if that income reaches $1,250. A child having an income in excess of $950, except from employment as a nurse in training, may not be claimed as a dependant, although a full deduction may be taken if the income is less than that amount. But these are provisions that do not in any way override the basic statement that the individual is the taxable unit under Canadian personal income tax.

Because the individual is the tax unit serious equity and enforcement problems arise.

PROBLEMS OF EQUITY IN THE PRESENT APPROACH

As we have said, in equity an individual should pay higher taxes than a married couple with the same income because the non-discretionary expenses of a couple are greater than those of an individual. However, while two cannot live as cheaply as one, economies are possible when two people share bed and board. To recognize this reduction in total non-discretionary expense on marriage, we believe that in the upper and middle income brackets the tax payable by a married couple should be greater than the sum of the income taxes payable by two single individuals, each of whom has one half the income of the couple.

The present system does not meet the latter requirement. It is true that the couple pays less tax than an individual with the same income, but when husband and wife have equal incomes the tax on the couple is the same as the tax on two single individuals with the same incomes. The failure to impose higher taxes on a couple under these circumstances is, we believe, unfair, for it ignores the economies of living together.

The taxes paid by a married couple under the present system depend upon the proportion of the income received by each of the members. The tax on the couple is least when the incomes of husband and wife are equal; the tax is greatest when all of the income is received by either the husband or by the wife. This leads to ludicrous results. Consider two couples with no dependants. Each has an income of $8,000 a year. Under the present system (1965), if all of the income of one couple was received by the husband, the federal tax (excluding old age security tax and taking the standard deduction) would be $976.60. If, in the case of the other couple, husband and wife each received $4,000 the total federal tax on the couple would be $765.70. We can see no justification whatsoever for this difference of about $200, 1/ particularly if all the income is from property and neither spouse is employed.

Complications are introduced when comparisons are made between couples that have no wage earner, one wage earner, and two wage earners (we ignore dependants for purposes of this discussion). It can be argued that where there are two couples with the same total money income the couple with one wage earner should pay higher taxes than the couple with two wage earners, because the one-worker couple should be taxed on the imputed income of the housewife. This justification of one of the features of the present tax system cannot be dismissed out of hand. As we pointed out in Chapter 8, imputed income should, in principle, be brought into the tax base. But, as we also said, there are insuperable valuation problems. Admittedly, arbitrary adjustments can be made, but there seems to us no justification for taxing the imputed income of the housewife and not taxing other forms of

imputed income. We can think of no way of arriving at even an arbitrary method of taxing the imputed income under these circumstances; the unemployed individual may be retired, unable to find work, unemployable, or just plain indolent. If imputed income cannot be taxed with even a modicum of consistency, we do not think it should be taxed arbitrarily when it is convenient to do so and ignored when there are difficulties. We therefore reject the idea that there should be differences in tax between couples with the same aggregate income as a method of taxing the imputed income of husbands and wives who are not working outside the home.

Where a married couple has children, under the present system the only effect on the tax liabilities of the parents is that they can claim a deduction for each dependent child unless he or she has income in excess of $950 or is a nurse in training. If a dependent child has income of less than $950, that income is available to discharge expenses that would otherwise be borne by the parents, but it is free of tax. If a minor child who is a member of a household has taxable income, while the income is available to meet expenses of the family, it is taxable at the child's graduated rates which would normally be much lower than if the child's income was treated as additional income of the parents. Thus, under the present system, income of children which increases the family's ability to pay is either free of tax or is taxed at relatively low rates.

Other anomalies exist in connection with the gift tax and estate tax. In view of the liberal annual gift tax exemptions, transfers can be made over a period of years in such a way as to avoid gift tax and avoid or reduce estate tax. However, if this is not done and substantial assets are accumulated, they may eventually be subject to a heavy estate tax which is imposed on the same basis regardless of whether the assets are left to a member of the donor's family. Suppose that two families contrasted as A and B, have each accumulated $200,000. In each case the husband and wife presumably have both contributed to the earning and saving of this amount in one way or another. In the case

of Family A the assets may all be owned by the husband. In the case of Family B they may be owned as to one half by each spouse (either as a result of a gift programme or otherwise). If the husband in each family should die before his wife, the estate tax payable on the death of the husband in Family A would be much greater than that payable on the death of the husband in Family B. If in each family the wife were to die first leaving the assets to her husband, the estate taxes would be greater in Family B than in Family A. A third family, Family C, might avoid estate taxes on the death of both spouses by having part of the assets accumulated in a trust for their children. If the husband in Family A were to make a substantial gift to his wife or children in his lifetime, this might result in a gift tax which would have been avoided by Family B and Family C. While in most families the earning and saving of income is a co-operative effort, the taxes which arise on transfers between family members under the present system can vary widely, depending on the arrangements made as to legal ownership of assets, on what programmes of gifts are carried out, and on the circumstance of which spouse dies first.

PROBLEMS OF ENFORCEMENT IN THE PRESENT SYSTEM

The present system, with its emphasis on taxation of the individual, has had the effect of producing a tax penalty and at the same time the means for avoiding it. A taxpayer whose income comes from investments or rents could give some of his income-producing assets to his wife, with resulting tax saving, were it not for special statutory provisions. This income-splitting possibility was recognized from the inception of the income tax in Canada, and the original Income War Tax Act, 1917, provided that the income from property transferred by a person to his spouse or a member of his family should be that of the transferor and not that of the transferee, unless the Minister was satisfied that the transfer was not made for the purpose of evading tax 2/.

Constant pressure, caused by higher tax rates and the administrative difficulties of distinguishing between bona fide cases and tax devices, has resulted in a steady broadening of this original provision through the years. The provisions of the Act now cover not only transfers between spouses but also transfers to persons under 19 years of age by anyone, 3/ and certain transfers in trust; 4/ they disallow salaries paid by one spouse to another in a proprietorship or partnership; 5/ and give the Minister power in his discretion to allocate to one spouse the income of a husband-and-wife partnership 6/.

These provisions were subject to sharp criticism by many of the witnesses appearing before us. It was said that they are inconsistent and discriminatory as between taxpayers, and are too rigid and restrictive in dealing with relationships between spouses. The following are some examples of anomalies that have arisen.

Section 21(1) of the Act provides that if a person transfers "property" to a spouse, the income from that property, or property substituted therefor, shall be deemed to be income of the transferor and section 22(1) likewise deems to be income of the transferor the income from property transferred to a person under 19 years of age. However, it has been held by the courts that a loan is not a transfer of property. Consequently, where money supplied by a husband to acquire for his wife an interest in a partnership venture was supplied by way of repayment of a loan previously made by the wife, section 21(1) did not apply; the repayment was not a transfer of property and in any event the income derived from its use was not income from property but income from a business 7/. And where a father made a loan to trustees, the loan being used for the purchase of a building to be held in trust for the lender's minor children, it was held that the rental income from the building was not the income of the father 8/. However, a sale of property to a spouse in return for her promissory note was held to be a transfer of property which was caught by section 21(1). 9/

If a husband is the employer of his wife, he is prohibited by section 21(2) from deducting remuneration paid to his wife for her services to his business; but if the business is incorporated the corporation may deduct a reasonable amount paid to the wife of the controlling shareholder for her services to the business, since the corporation is an entity separate from its shareholders.

We conclude that the present system is lacking in essential fairness between families in similar circumstances and that attempts to prevent abuses of the system have produced serious anomalies and rigidities. Most of these results are inherent in the concept that each individual is a separate taxable entity. Taxation of the individual in almost total disregard for his inevitably close financial and economic ties with the other members of the basic social unit of which he is ordinarily a member, the family, is in our view another striking instance of the lack of a comprehensive and rational pattern in the present tax system. In keeping with our general theme that the scope of our tax concepts should be broadened and made more consistent in order to achieve equity, we recommend that the family be treated as a tax unit and taxed on a rate schedule applicable to family units. Individuals who are not members of a family unit would continue to be treated as separate tax units and would be taxed on a schedule applicable to individuals.

THE FAMILY AS A TAX UNIT

We regard the family as consisting of husband, wife and dependent children, if any. The main result of taxing the family as a unit would be that the income of the members of the family would be aggregated, and that allowances and tax rates would be applied which were appropriate to that combined income. There are, however, several further consequences that we examine in the balance of this chapter. Many of these are of importance to the aggregation of income and in some instances represent substantial reductions or increases of tax by comparison with present arrangements.

Our first responsibility is to establish clearly our grounds for recommending the family as the basic tax unit. In a sense, we have already made the case by establishing the inadequacies of taxing the members of a family as individual tax units, the inference being that only by taxing the total family income can these shortcomings be removed. But the case is much stronger than that. We believe firmly that the family is today, as it has been for many centuries, the basic economic unit in society. Although few marriages are entered into for purely financial reasons, as soon as a marriage is contracted it is the continued income and financial position of the family which is ordinarily of primary concern, not the income and financial position of the individual members. Thus, the married couple itself adopts the economic concept of the family as the income unit from the outset. In western society the wife's direct financial contribution to the family income through employment is frequently substantial. It is probably even more true that the newly formed family acts as a financial unit in making its expenditures. Family income is normally budgeted between current and capital outlays, and major decisions involving the latter are usually made jointly by the spouses. Budget decisions indirectly influence family saving and provisions for retirement, although these are frequently determined on a contractual basis through insurance and pension arrangements, both of which have implications for the family rather than for the individual directly involved.

Where the family grows by the addition of children, further important financial and economic decisions are made in the family as a unit. Questions of the extent of education, time of entrance into the labour force and, frequently, choices of a career are decided on a family basis, although of course there are many exceptions to this statement. In some circumstances the income of the child is added to the family income, and, even where this is not done directly, the fact that a child has income of his own will have some bearing on the main family expenditure decisions. Certainly when the child becomes self-supporting he is normally expected to relieve the family

of further expenditure on his behalf. Thus, the income position of children has an important bearing on the family income, although frequently in an indirect way.

With the marriage of the children a new cycle commences, with attendant financial consequences for both the old family unit and the new. The old family unit survives in the persons of the parents, usually with drastically different financial circumstances from those of the new unit. Where assets have been acquired during the lifetime of the old family unit, arrangements must be made for their disposition during retirement or at death. Again, the primary considerations are not those concerning the individual but the family as a whole and, in particular, those concerning the future maintenance of a surviving spouse. Moreover, the prospect of ultimate dissolution of the family unit when both spouses have died is also usually foreseen, and arrangements are made for the disposition of any remaining assets at that time.

We should emphasize that the preceding description is not an attempt to present an idyllic picture of family life in Canada. We are not concerned in this Report with sociological issues, but with taxation, and our firm conclusion is that the family, as we find it in our modern society, continues to be the basic economic and financial entity. We therefore propose that this fact should be reflected in our tax system and that the family should be adopted as a basic unit for income tax purposes. As we have said, where the individual is not part of a family, he should continue to be a separate tax unit as at present.

Some element of aggregation is now a common feature of the tax systems of nearly all important countries in the world, including the United States, the United Kingdom and nearly all European countries. Canada is a conspicuous exception in its adherence to the individual basis of taxation. The concept of aggregation, simple enough in itself, takes on added significance when it is recalled that, under our proposals for a new comprehensive tax base,

"income" would include virtually all gifts and inheritances received as well as gains realized on property dispositions, with a deemed realization at death of an individual taxpayer or of the surviving spouse in a family unit and a deemed realization on giving up Canadian residence. As we have said, the adoption of the family as one of the basic units for income taxation would mean that transfers of property within the family unit would not be subject to taxation. It is not that transfers between husband and wife, or between parents and their minor children, would be exempt from tax; it is simply that these transfers would be removed from the purview of the tax system. Similarly, with regard to realizations of property gains, because it is only transfers between family units that should have tax implications, we later recommend that it should be deemed that no realization takes place on a transfer of property between members of a family unit. Gifts or bequests from one member of a family unit to another would not give rise to tax on any accrued gain on such property. Only the flows of income into the family unit and the transfers of property between family units would generally be of tax significance.

To remove any misconception, we would point out that our proposals do not involve any change in the ownership of assets of the members of the family unit or in their respective rights to income; our proposals relate simply to the treatment of income for tax purposes.

We deal separately with two types of family unit, one composed of the couple without dependent children, the other of the couple with dependent children. Later in this chapter we recommend that dependent children should be included in the family unit; but for expository purposes it is better to discuss first the family unit without dependants.

FAMILY UNIT CONSISTING OF SPOUSES ONLY

Husbands and wives 10/ resident in Canada would be required to use the family unit rate schedule in the determination of tax. Normally, the couple

would aggregate their incomes and the tax on this aggregate would be calculated under the family unit rate schedule. However, spouses who do not wish to disclose their incomes to one another could, at the option of either, 11/ file separate returns with the tax calculated as follows: each spouse would multiply his or her income by two; the tax on this doubled income would be computed from the family unit rate schedule; the tax payable by the spouse would be one half of the amount of the tax computed in this manner. This would usually result in somewhat higher family taxes than if they had aggregated their incomes.

Commencement of a Family Unit

A family tax unit would commence at the beginning of the taxation year in which a resident couple were married. Following that date, the husband and wife (unless they elect to file separate returns) would be required to aggregate their incomes and to determine their joint tax liability using the family rate schedule. Property held by either husband or wife at the time of the marriage would not be brought into the income of the new family unit. In Chapter 17 we recommend that each individual should have a lifetime exemption for gifts in the amount of $5,000. On marriage, the unused portion of this exemption for each spouse would be available to the family. Thus, if both husband and wife lost their dependent status as a result of their marriage, the couple would have a lifetime gift exemption of $10,000. Similarly, if husband and wife had unused higher education tax credits (discussed in Chapter 12), these could be carried forward and used to offset the tax levied against the family.

To prevent taxpayers from averaging income received prior to marriage when the rates for a different unit were applicable with income received after marriage, it would be necessary to require that years prior to the formation of a family unit could not be included with years subsequent to the formation of a family unit for purposes of block averaging. However, taxpayers willing to make Income Adjustment Account deposits 12/ while

filing as individuals would not be required to take them into income before marriage because we believe that Income Adjustment Account deposits effectively reduce economic power and should be taxed without regard to changes in the tax unit of the depositors when brought into income.

Aggregation of Income

Other things being equal, the sum of the tax bases of husband and wife filing separately would be equal to the tax base of a couple filing jointly. In neither case would transfers of property between spouses be brought into the tax base nor would there be a realization of property gains on property transferred between spouses 13/. In all other respects the tax base (or bases) of the couple would be determined in the same way as for an unattached individual. Income flowing to the couple from outside the family unit would be included in their aggregate tax base or in their separate tax bases; gains on the disposition of property, other than on transfers between the two spouses, would be included in their aggregate tax base or in their separate tax bases.

Childless Marriages Lasting Less Than Five Years

The only restriction we propose on tax-free transfers between spouses is one we believe necessary to reduce tax avoidance through artificially arranged marriages. We recommend that with one exception, property should be permitted to be transferred from one spouse to the other free of tax only after the marriage has lasted for five years, or after the couple has a natural-born child, whichever is earlier. The exception would be that one spouse could make tax-free transfers to the other spouse during this period equal to one half of the income after tax reported by the family unit during the marriage. This is an administratively simple method of permitting transfers of property which may have been accumulated after marriage as a result of sacrifices made by both husband and wife.

Income Splitting

If this approach is adopted, the advantages of income splitting between husband and wife would be removed. Indeed, unless the incomes of the spouses were identical, a small penalty would be imposed on those couples who elect to file separately. Therefore, it would be possible to eliminate all the provisions intended to prevent income splitting between husband and wife found in section 21 of the Act. This would end the unfair discrimination against a woman working for her husband, husband-and-wife partnerships, and the anomalies arising under the present income attribution rules.

Termination of a Family Unit

A family unit for tax purposes would not terminate on the death of one of the spouses. There would be no tax consequences resulting from a transfer of property from the decedent spouse to the surviving spouse 14/. However, where the surviving spouse had no dependants, even though the family unit would continue, the annual tax liability of the survivor should be determined according to the individual rate schedule. If this were not the case, a childless woman widowed at age 25 who did not remarry would have, for the rest of her life, a lower tax rate than a spinster with the same income.

The family unit with no dependent children would terminate under four circumstances. These circumstances, and the attendant tax consequences, are spelled out below. It is assumed that the couple was married for at least five years prior to the termination of the unit.

1. On the death of both spouses or on the death of a surviving spouse who has not remarried, the family unit would terminate and the following tax consequences would ensue:

   a) There would be a deemed realization of property gains to the defunct family unit.

b) Property passing from the terminating unit to other units would be brought into the income of the recipient units.

2. On the remarriage of a surviving spouse the family unit would terminate, but there would be no tax consequences. The following would be the position:

   a) There would be no deemed realization of property gains to be dissolved family unit except with respect to any property passing to third parties.

   b) Property passing from the original unit to the new unit would not be included in the income of the new unit.

   We appreciate that in a few cases this may result in deferment of tax, but we do not think that this would be serious. In our view the consequences of marriage should be the same regardless of the source from which either of the partners derived his or her property. Any transfer from the former spouse which had been held in trust and not transferred to the surviving spouse until after the remarriage should be free of tax even though the transfer is to another tax unit.

3. On the divorce or legal separation of the spouses the family unit would terminate, but there would be no tax consequences. To be specific, we note the following:

   a) There would be no deemed realization of property gains to the dissolved family unit except with respect to property passing to third parties.

   b) The two new tax units created by the dissolution of the old family unit would not be required to bring property taken from the old unit into income, regardless of which spouse originally held the property.

c) Alimony and maintenance payments made after the divorce or separation would continue to be treated substantially as at present. The payments would be deductible to the tax unit making them and would be taxable as income to the recipient tax unit. This treatment should apply whether or not the payments are made on a periodic basis.

4. If both spouses ceased to be resident 15/ the family unit would be terminated with the same tax consequences as we have described under 1. If one spouse ceased to be resident, while the other remained resident, the family unit would not be terminated, but there would be a deemed realization of property gains with respect to the property of the spouse leaving the country.

To sum up the above proposals, for the great majority of married couples, that is, those who remain resident in Canada and are not divorced or separated, the family unit described would offer the right of taxation under a family unit rate schedule for joint incomes, tax-free transfer of property within the family unit during its existence, and no deemed realization of property gains until the death of both spouses. In terms of the present tax structure, this would mean that neither gift tax nor death tax would be levied on transfers between spouses. Only at the death of both spouses would a tax become payable on the deemed realization of the gains on property accrued by the family at that time. Under our proposed comprehensive tax base, transfers to persons outside the family unit, including transfers made at the death of the surviving spouse, would result in deemed dispositions by the family unit and the net amount after tax which is transferred would be included in the income of the recipient tax unit.

FAMILY UNIT WITH DEPENDENT CHILDREN INCLUDED

Persuasive arguments can be advanced for both the inclusion and exclusion of dependent children from the family unit. In most families the income of

dependent children is taken into account in family decision making. In low income families the children are often expected to make a contribution to the general support of the family; in well-to-do families the child with income is often expected to buy such things as clothing and entertainment. These expenditures would otherwise have to be made, at least in part, by the parents. In either case the income of the child increases the economic power of the family and should be taxed at the marginal rate of the family. The inclusion of a child's income with that of his parents would nullify tax avoidance schemes under which property income could be diverted to the children. In addition to these considerations, there is an administrative argument in favour of including children in the family unit. If children were included in the family unit the transactions between parents and their children would have no tax consequences for the same reason that transactions between spouses would have no tax consequences. But if children were excluded from the family unit, it would be necessary to define and to value the "gifts" made by parents to their children. Obviously the provision of sustenance to a child within the requirements of the law of support would not be defined as a gift; but at some point the distinction between sustenance and gifts would have to be drawn. Where is the line to be drawn between the use of the family car, the gift of an inexpensive used car, the gift of an extremely expensive car that can be disposed of for thousands of dollars, and the gift of a block of shares or the title to real property that can be sold for tens or even hundreds of thousands of dollars? To fail to tax these "big" gifts would result in the complete avoidance of tax by the child on substantial increases in his or her economic power.

On the negative side it can be argued that to include in family income the part-time earnings of the schoolboy and to tax them at full marginal family rates would be too harsh. It would also be unenforceable because these earnings would not be reported by many families, and would discourage the labour effort of minors.

Another argument can be made against the inclusion of children in the family unit. Some children receive large gifts from outside the family from benevolent grandparents, aunts, uncles and other relatives or friends. If children were included in the family unit without any relieving provisions these gifts would have to be brought into the income of the family and, if not consumed before the child left the family, again brought into the income of the child when he or she left the family. This would be the appropriate treatment if the gift to the child was considered by the child, and by the child's parents, as an addition to the economic power of the family, to be spent or saved by the family as it wished. However, if the gift were considered by the family as property "in trust" for the child, to be available to the child when he or she was no longer a member of the family, to tax it both to the family and then again to the recipient of the gift on leaving the family would be unfair, for the gift would not increase the economic power of the family.

We have come to the conclusion that the better of the two alternatives would be to hold to the principle that the family should be treated as an economic unit and generally to require that children 21 years of age or less be included in the family unit, with the income of these children aggregated with the income of the parents for tax purposes. However, we recommend several mitigating provisions that would, we believe, substantially reduce, if not entirely eliminate, the problems which this would create. These mitigating provisions are reviewed as we proceed with the discussion.

Definition of the Family Unit

We recommend, under the broader concept of the family unit we favour, that the following resident persons be treated as family units:

1. Husband and wife.
2. Husband and wife and dependent children.
3. A surviving spouse 16/.
4. A widower or widow and one or more dependent children.

5. A divorced or separated parent and one or more dependent children.
6. One or more dependent children who previously have been in a family unit but are separated from both their parents because the parents have died or have ceased to be resident or for some other reason.
7. A single individual and one or more dependent children. This would include an unmarried person with one or more adopted children, or an unmarried mother and her child or children.

Dependent children would be defined as unmarried children who are resident in Canada, natural-born or adopted, who were: 21 years of age and under; or over 21 years of age and mentally or physically infirm 17/.

Two options would also be provided. Under the first option, a child 21 years of age or under, but over the school-leaving age in the province in which he resided, not living with his parents and employed or carrying on a business on a full-time basis, could, at the option of the child or of the parents, withdraw from the family unit for tax purposes and file as an individual tax unit. This should accommodate the circumstance where a child, for one of a multitude of possible reasons, becomes self-sufficient at an early age.

Under the second option, a child over 21 but not over 25 years of age, attending a recognized institution of post-secondary education on a full-time basis could, if acceptable to both the child and his parents, elect to remain a member of the family unit. Under this option parents of a child attending university could obtain the credit which we recommend in Chapter 12 in recognition of the fee expenses incurred in attending university and the usual credit for a dependant which we propose in Chapter 11. The special credit for the living expenses of a student which is discussed in Chapter 12 would not be available to the parents as they would already be claiming the child as a dependant. The gift of a university education from the parents to the child would not be taxed to the child. The part-time employment or business income of the child in excess of the exemption

specified below would, however, be taxed to the parents if the child remained in the family unit.

We suggest that in no circumstance should actual support be the test of dependency for purposes of inclusion or exclusion of a child from the family unit.

Commencement of a Family Unit

The family unit would usually come into being at the commencement of the year in which a couple are married and this would have the tax consequences we discussed earlier in the chapter. However, a family unit for tax purposes would also be started when an unmarried woman has a child and retains custody of her child or children; when an unmarried individual adopts one or more children; or when a divorced or separated spouse retains custody of one or more dependants. In each case the first taxation year of the family unit would be the calendar year in which falls the event which causes its creation. The tax consequences in these circumstances would be the same as for a family tax unit created through marriage.

Aggregation of Income

If the parents were filing jointly, the income of a dependent child would be aggregated with the income of the family for tax purposes, in the same way that the income of spouses would be aggregated, and be subject to tax under the family rate schedule. If the spouses were filing separately, one of the parents would be required to aggregate, for tax purposes, the income of the dependent child with his or her income. In neither case would the parent(s) be required to have the tax return signed by the dependant. The parent(s) would be held responsible for the accuracy of the return.

It would be necessary to make provisions concerning the liabilities of the members of the family unit for the tax payable by the unit. We recommend that where there are two parents and they file a joint return, the parents

should be jointly and severally liable for the full amount of the tax. If they were not willing to assume this liability they could file separate returns on the basis mentioned earlier in this chapter. If there were only one parent in the unit that parent should be liable for the full amount of the tax payable by the unit. In addition, any dependent child should be liable for that portion of the tax allocable to his income which had been included in the family unit income. There should also be a provision that if a parent who has filed a separate return, or a child, has received a transfer of property from another member of the unit, he will be liable for the tax payable by the unit to the extent of the amount so received in addition to any other liability which he has under the above rules.

Primarily to reduce the problems of enforcement, the family unit would be granted an annual deduction of $500 for employment or business income earned at arm's length by each dependent child. Only the amount in excess of $500 would be aggregated with the income of the family. This provision is designed to exclude from tax the small sums earned by children from casual employment because it would be impossible to enforce the reporting of such sums. We have not suggested an amount larger than $500 because we feel that this amount would be sufficient to meet the administrative problems.

Transfers of Property

Transfers of property within the family unit would have no tax consequences for the donor or the donee. Transfers between parents and dependent children would be treated in the same way as transfers between parents; they would be ignored for tax purposes. Transfers to a dependant from outside the family unit would, however, be taxable to the family unit, with one exception.

To avoid the problem of taxing large gifts to a dependent child from outside of the family unit, first to the family and then to the child when

he or she leaves the family, we recommend that the child (or the child's parent or guardian) should be permitted to deposit in the name of the child the amount of any gift or bequest to the child from outside the family unit in an interest-bearing Income Adjustment Account 18/ in the year in which it was received. These deposits would be deductible from the income of the family unit. The interest on such deposits would be paid only on withdrawal and would be brought into income at that time. Any withdrawals from these Accounts made while the child was a member of the family unit would be brought into the income of the family. Withdrawal would have to be made when the child ceased to be a member of the family unit and would be brought into the income of the new tax unit of the child at that time. Withdrawals from such an Account could be averaged in one of the ways described in Chapter 13.

Saving of Dependants from Employment
or Business Income

The employment or business income earned at arm's length by dependants in excess of the allowance of $500 noted above, may be considered, both by the dependant and the family of the dependant, as funds to be put aside to cover future expenditures by the child after leaving the family unit. Here, too, it would seem unfair to require that these funds be brought into family income and then into the income of the child on leaving the family. We therefore recommend that the child should be permitted to deposit these amounts in excess of $500 in an Income Adjustment Account, and that such deposits should be deducted from the income of the family. These deposits would be brought into the income of the tax unit of which the depositor is a member at the time of withdrawal in the manner discussed above, and would have to be brought into the income of the new tax unit when the child ceased to be a member of the original family unit.

Withdrawal of a Child
From a Family Unit

A child would cease to be a member of his original family unit on marriage, on death, on ceasing to qualify as a dependant because of

age, on ceasing to be a resident, or if he "opted out" under the conditions specified above, or if he is adopted by another family.

Two questions arise when a child has ceased to be a member of the original family unit. How should unrealized gains on property which the child takes from the original family unit be taxed? How should property transferred from the original unit be taxed to the new unit?

We recommend that unrealized gains on property withdrawn by the child from the original family unit should be taxed as income to the original family unit in the year in which the child withdraws. There would be an exception to this rule in the case of a dependent child who was an orphan and who was adopted by another family. In that case there would be no deemed realization, but the property belonging to the orphan would retain the cost basis which it had in the original unit.

In order to preserve the concept that gifts are part of the comprehensive tax base, we recommend that the child be required to include in his income, as a new tax unit, in the year in which he ceased to be a member of the original family unit, unless this was due to his adoption, the market value of any property taken with him from the original unit in excess of his lifetime exemption of $5,000 and his annual exemption for the year. The lifetime exemption should be sufficient to ensure that most individuals establishing a new tax unit would be free of any tax on their starting assets. We have not suggested a larger exemption because we feel that it would unduly increase the inequity inherent in any exemption that only applies to one kind of income. The exclusion of up to $5,000 is a lifetime concessionary allowance which would be available to every individual who has ceased to be dependent. As recommended in Chapter 17, it could be used for gifts and bequests from outside the unit at any time.

If a child should become non-resident while the parents remain resident, the child would cease to be a member of the family unit unless he elects to

continue to be taxed as a resident. If he does not so elect and ceases to be a member of the family unit, he would be required to include in income all property (in excess of the exemptions) which he takes with him from the unit. In addition, there would be a deemed realization to the family unit of that property. Any subsequent gifts of property to the child by his parents would likewise result in deemed realizations to the family unit and would be subject to withholding tax. For these reasons a child who becomes non-resident, to attend university or otherwise, would probably elect to continue to be taxed as a resident as long as he is qualified to continue to be a member of the family unit.

If the child has ceased to be a member of the family unit by reason of his marriage, and has thereby formed a new family unit, the latter unit would bring the property transferred from the original family unit, in excess of the aggregate unused lifetime exemptions of the couple, into the income of the new family unit in its first taxation year. This property would be taxed according to the family rate schedule like any other income. The child leaving the family for reasons other than marriage would bring the property transferred from the old unit, in excess of the $5,000 lifetime exemption, into his individual tax unit, and it would be taxed with other income on the individual rate schedule. In either case, the new tax unit would be able to take advantage of the income-averaging provisions discussed in Chapter 13. Any further gifts or bequests to the new unit from any source would be brought into the tax base of the new unit, subject to the unused lifetime exemption and the annual exemptions we recommend in Chapter 17. The suggested annual exemptions are $250 for a person filing as a single individual, $250 for each spouse in a family unit, and $100 for each child family unit. Such a provision should exempt from tax the normal flow of personal gifts.

The aggregation of a dependant's income with the income of his family would eliminate any income-splitting advantage in gifts to dependent members

of the family unit. To this extent, the sections attributing income from property transferred to persons under 19 years of age could be eliminated from the Act as well as the sections regarding transfers in trust 19/. Income splitting could still be a motive in gifts from outside the family unit to minors who had "opted out". A substantial gift from a grandfather to minor grandchildren would be a typical example. However, the conditions we recommend under which opting out would be permitted are so stringent, we doubt that this alternative would be used for tax minimization purposes. Moreover, the tax payable on the transfer, both by the donor and the donee, would usually offset any advantage of the lower tax rate on the subsequent income of the donee. For these reasons we recommend that the anti-income-splitting provisions of sections 21 and 22 should be repealed in their entirety. It is not possible, with all the changes in tax bases and rates we recommend, to be sure that possibilities for income splitting would not arise, so that it would be necessary to review this area from time to time.

Termination of a Family Unit

A family unit in which there are no dependent children would terminate in the ways and with the consequences already discussed. Where the family unit contained a dependent child or children, however, additional rules would be necessary.

In the event of divorce or legal separation of the spouses, the family unit would terminate but there would be no tax consequences. There would be no deemed realization of property gains to the dissolved family unit and the two tax units created on the termination of the old family unit would not be required to bring into income property taken from the old unit. A divorced or separated spouse who retained custody of one or more dependent children would form a new family unit with those children. A spouse who did not retain custody of any dependent children would form a new single tax unit.

In the event that one of the spouses in a family tax unit ceased to be resident in Canada but the other remained resident, the family unit would be deemed to continue. Similarly, if the sole parent or both parents in a family unit ceased to be resident in Canada but they had one or more dependent children who continued to be resident in Canada, the unit would continue. In all of the circumstances referred to in this paragraph there would be a deemed realization of property gains to the original family unit only with respect to the property of a member or members of the unit who ceased to be resident in Canada. In the event that all members of a family unit became non-resident, the family unit would terminate and there would be a deemed realization of all of the property of the family unit at the fair market value.

In the event of the death of a spouse, the family unit would be deemed to continue in two circumstances:

1. Where a spouse survived, with or without a dependent child or children.
2. Where there was no surviving spouse but a dependent child or children survived.

In each of these circumstances there would be no deemed realization of property gains to the family unit on property passing to continuing members. The continuing members would not be taxed on property passing to them by reason of the death.

Where there was a family unit consisting only of a dependent child or children, it would continue until the last dependent child ceased to be a dependant (as defined). At that time there would be a deemed realization of the previously unrealized gains on property of the family unit unless the last dependent child ceased to be a member by reason of being adopted.

The tax liability of a family unit consisting of one dependent child would be determined by the individual rate schedule, as would the tax liability for a tax unit consisting of a surviving spouse with no dependants.

In the event of the marriage of a surviving spouse or an unmarried person who had a dependent child or dependent children, their tax unit would terminate and they would become members of a new tax unit with the new spouse. In this event there would be no deemed realization to the former unit and the value of their property would not be added to the income of the new unit.

OTHER DEPENDANTS

We have also considered whether dependants other than children should be included in the family unit for tax purposes. There is no doubt that another dependant, such as a parent, is often an integral part of the family unit, both in physical presence and by reason of affecting family expenditures. However, there are other cases where this social relationship exists only in part, if at all. In addition, we were unable to develop adequate provisions to prevent a number of tax minimization devices, particularly in the area of gifts and bequests, that could be employed if the family unit were expanded beyond the limits we have already recommended.

Therefore, we recommend that the family unit should only encompass spouses and dependent children (as defined). This does not mean, however, that no recognition should be given to expenditures by the family to support close relatives who form, in effect, part of the family group. We recommend in Chapter 12 that a tax credit be granted of up to $100 for such expenditures made to or on behalf of a close relative. More important, we recommend that complete dependence should not be a requirement for the claiming of this credit. It should also be noted that although gifts and bequests to relatives must be included in the income of the recipient to the extent that they exceed the proposed exemption, the tax rate schedules and credits that we propose would mean that little or no income tax would be payable by a relative who only received a moderate amount of assistance.

Common Law Wives

Couples sometimes live together in common law relationship but are not legally married. They live as a family, often with children. Sometimes one or both of the partners have a legal spouse but are separated legally or otherwise. We think it is equitable that such couples and their children should be treated as family units for income tax purposes regardless of the legal status of their marriage. However, to make this administratively feasible there would have to be a definite rule for determining when such a relationship should be recognized for income tax purposes. This could be accomplished by a provision that a man and woman who were not legally married would be regarded as spouses if they had cohabited as man and wife for at least a year and had filed a joint declaration that they wished to be treated as man and wife for income tax purposes. If a person who was legally married to someone else and not legally separated made such a declaration, this would terminate the former family unit in the same way as a legal separation. It should be provided that when such a declaration was filed each of the parties would be deemed to be the spouse of the other and not of any other person. Any child who was dependent for support upon either or both of the parties, and not on any other person, would be included in the family unit on the same basis as the children of any other family. If the parties separated and remained separated for a period of at least one year this would have the same effect as a legal separation of a married couple.

CONCLUSIONS AND RECOMMENDATIONS

1. The present tax system treats the individual rather than the family as the basic unit for tax purposes. In our view this leads to inequities because we believe it is the ability to pay of the family, rather than of the individual members of the family, that should be taken into account in determining tax liabilities.

2. In our opinion a married couple should pay less tax than a single

individual with the same aggregate income. However, we believe that at most income levels a married couple should pay higher taxes than two single individuals, each of whom has half the income of the couple, because of the economies that can be realized when two people live together. This result is not achieved with the present system.

3. The tax liabilities of married couples should be independent of the proportion of total income received by husband or wife. This result is not achieved under the present system, for the couple comprised of a husband and wife who have identical incomes pays a lower tax than a couple with the same income received by one of the spouses.

4. These problems could be eliminated by the aggregation of the income of husband and wife. By taxing the total income of the couple under a rate schedule that bears an appropriate relationship to the rate schedule applicable to individuals, a more equitable allocation of taxes between single individuals and couples could be achieved.

5. The aggregation of the income of husband and wife would have the important result that transactions between the two would have no tax consequences. In particular, inter vivos and testamentary transfers of property between spouses would not be subject to tax notwithstanding the general rule that gifts are included in the income of the donee tax unit.

6. Adopting the family as one of the basic units for tax purposes would have the advantage that the problems created by income splitting between husband and wife under the present approach would be largely eliminated. The restrictive sections of the Act that are now necessary to prevent income splitting have been sharply criticized as discriminatory and inconsistent. These restrictions could be abolished.

7. There are both advantages and disadvantages to the aggregation of the income of dependent children with family income. Except under unusual

circumstances, compulsory aggregation of the income of dependent children with that of their parents would be preferable from an equity point of view, and the administrative problems would probably be less with aggregation. We therefore recommend compulsory aggregation of the income of dependent children with family income, with modifications that would provide the flexibility necessary to accommodate the diverse relationships that prevail between parents and their children and the unique character of the income sometimes received by dependent children.

THE COMPOSITION OF THE FAMILY UNIT

8. A husband and wife, if they are Canadian residents, should be treated as a tax unit (the "family unit") for tax purposes. The family unit would commence at the beginning of the taxation year in which the marriage occurred.

9. Where there were resident dependent children, they should also form part of the family unit for tax purposes. With two exceptions, dependent children should be defined as unmarried children 21 years of age or less, or over 21 and infirm. Actual support should not be a test of dependency. Other close relatives dependent upon the family unit for support should not be included in the family unit for tax purposes. However, a tax credit should be available that would be related to expenditures made to support such dependants.

10. A family unit should also be formed at the commencement of the year in which any of the following events occurred: an unmarried woman has a child; an unmarried individual adopts one or more children; or a divorced or separated spouse retains custody of one or more dependent children. The unit would consist of the parent and the dependent child or children.

OPTIONS FOR DEPENDENT CHILDREN

11. Two options should be available with respect to dependent status:

    a) An unmarried resident child 21 years of age or less, but over school-leaving age, who lived away from home and was employed or operated a business on a full-time basis, should be permitted to file as an individual, at the option of the child <u>or</u> of the child's parents.

    b) An unmarried resident child over 21 years of age but not over 25 who attended a recognized institution of post-secondary education on a full-time basis should be permitted, if acceptable to <u>both</u> the child and his or her parents, to remain a member of the family unit.

FAMILY RATE SCHEDULE

12. Normally, the income of the family unit would be aggregated on a joint return and this aggregate taxed on a "family unit rate schedule". Under that schedule family units would pay less tax than an individual with the same income.

13. Either spouse should be permitted to elect that they would not aggregate their incomes. In that event they would file separate returns and be taxed separately on the family unit rate schedule in a way that would usually involve somewhat higher taxes (in total) than if they had aggregated. A dependent child's income (in excess of the exemption referred to below) if any, would be aggregated with that of either parent.

LIABILITY FOR TAX PAYABLE BY FAMILY UNIT

14. The spouses should be jointly and severally liable for the tax payable by the family unit unless they file separate returns. If there is

only one parent, he or she would be liable for the tax. A dependent child with income should be liable for the tax allocable to that income.

EXEMPT INCOME FOR DEPENDENT CHILDREN

15. Employment or business income up to $500 earned at arm's length by a child in a family unit should be exempt from tax and would therefore not be subject to aggregation. Only the dependent child's income in excess of that sum should be aggregated with the income of the family unit.

INDIVIDUAL RATE SCHEDULE

16. A person who was not a member of a family unit should be treated as an "individual unit" and should be taxed on the "individual unit rate schedule".

TRANSFERS OF PROPERTY WITHIN FAMILY UNIT

17. With one exception, transfers of property, either <u>inter vivos</u> or on death, between members of a family unit should not involve a deemed disposition or the receipt of income. For example, a husband would be able to make <u>inter vivos</u> and testamentary gifts to his wife or dependent child free of any tax.

18. To prevent abuse through marriages undertaken solely for the purpose of reducing taxes on transfers of property, it should be provided that tax-free transfers would not be permitted until the marriage had lasted for five years or until there was a natural-born child of the marriage, whichever was earlier. One exception to this would be that tax-free transfers would be allowed during this period up to one half of the income after tax reported by the family unit.

TRANSFERS OF PROPERTY BETWEEN UNITS

19. Gifts of assets from outside the family unit to a member of the family unit should be treated as income of the family unit, with the exception noted below.

20. The following special rules should apply to dependent children:

a) A dependent child who received gifts or bequests from outside the family unit should be permitted to deposit such gifts or bequests, or the monetary value thereof, in an interest-bearing Income Adjustment Account. Such deposits would be deducted from family income for tax purposes. Withdrawals from these deposits would be taxable to the unit of which the donee is a member at the time of the withdrawal. Withdrawal would be compulsory when the child established a new tax unit.

b) A dependent child with income earned at arm's length from employment or business in excess of the $500 annual allowance should be permitted to deposit the excess in an Income Adjustment Account on the same basis as gifts from outside the family unit.

c) On marriage, on ceasing to be a resident, and on ceasing to qualify as a dependent child under the definitions given in 9 above:

i) there should be a deemed realization of gains or losses to the original family unit, on the property the child takes to the new unit;

ii) the child should bring this property into the income of his or her new tax unit in its first taxation year at the fair market value, subject to a lifetime exemption of $5,000 and the applicable annual exemption for gifts; if the child has ceased to be resident the property would be subject to withholding tax as a gift.

d) On the adoption of a dependent child who is an orphan by another family unit there should be no deemed realization and the property of the child should not be included in the income of the new unit.

TERMINATION OF THE INDIVIDUAL TAX UNIT

21. The individual tax unit should terminate on death, on marriage or on giving up Canadian residence. Except on marriage there would be a deemed realization of property gains to the terminating unit and the property passing to other resident units would be brought into the income of the recipient unit. On marriage there would be no deemed realization and the property taken from the individual tax unit to the new family unit created by the marriage would not be brought into the income of the new unit. All deemed realizations of property would be at the fair market value.

TERMINATION OF THE FAMILY TAX UNIT

22. The family tax unit should terminate if both spouses ceased to be resident and there were no resident dependent children. There would be a deemed realization of property gains to the terminating unit. Property passing from the terminating unit to resident tax units would be brought into income by the latter. If a person becoming non-resident elects to continue to be taxed as a resident, he should be regarded as a resident for all purposes.

23. If one spouse became non-resident there should be a deemed realization of gains on the property of that spouse. However, the family tax unit would not terminate if one spouse remained resident or if there were resident dependent children.

24. The family tax unit should terminate if the spouses were divorced or legally separated. However, there would be no deemed realization of property gains to the family unit, and the property taken by any of

the members of the family from the terminated unit would not be brought into the income of the new tax units they formed.

25. The family unit should terminate:

a) On the death of the surviving spouse if there were no resident dependent children.

b) On the remarriage of the surviving spouse.

c) On the surviving spouse ceasing to be resident if there were no resident dependent children.

d) On the loss of dependent status by all members of the family unit of parents who have died or have ceased to be resident leaving dependent children resident in Canada.

In the circumstances referred to in paragraphs (a), (c) and (d) there would be a deemed realization of all property gains to the family unit. In cases (a) and (d) all property transferred from the terminated unit, after providing for its tax liability, would be brought into the income of recipient tax units. In the case of remarriage of a surviving spouse there would be no deemed realization and the property of the surviving spouse would not be included in the income of the new unit. In the event of the marriage of a surviving spouse or of an unmarried person who has a dependent child or dependent children, all members of the tax unit would presumably become members of the new tax unit and there would be no deemed realization to the former unit or income to the new unit.

REFERENCES

1/ This difference is reduced to about $80 if the separate old age security tax is included.

2/ Section 4(4) of the Income War Tax Act, 1917, Chapter 28.

3/ Sections 21(1) and 22(1).

4/ Sections 21(1), 22(1) and (2).

5/ Under section 21(2), where a person has received remuneration as an employee of his spouse, the amount is not deducted in computing the spouse's income and is not included in the employee's income. Section 21(3) provides that where a person has received remuneration as the employee of a partnership in which his spouse was a partner, the proportion of the remuneration that the spouse's interest in the partnership was of the interests of all the partners is deemed to have been received by the spouse as part of his income for the year from the partnership.

6/ Section 21(4).

7/ Robins v. M.N.R., [1963] Ex. C.R. 171.

8/ Dunkelman v. M.N.R., [1960] Ex. C.R. 73.

9/ Campbell v. M.N.R., 63 DTC 493; 32 T.A.B.C. 203.

10/ See the discussion of the treatment of common law wives later in this chapter.

11/ We see no major difficulty in allowing the couple to decide whether to file separately or jointly each tax year if the procedure described above were followed.

12/ An Income Adjustment Account is a government-supervised account which we recommend and which is described in Chapter 13.

13/ Property transferred between spouses would be recorded at a cost basis equal to that of the donor spouse.

14/ As an alternative it could be stipulated that in these circumstances the family unit would terminate, but that there would be no tax consequences, as in the case of a divorce or legal separation. However, we believe the approach recommended not only puts greater emphasis on the tax significance of the family unit, but it also facilitates the treatment of life insurance and retirement income received by the surviving spouse.

15/ Unless both spouses elect to continue to be taxed as if they were resident in Canada. This procedure is discussed in Chapter 26. If such an election is made in any case where a person becomes non-resident, the tax consequences would be the same as if that person had continued to be resident.

16/ As stated above, where there is a surviving resident spouse without dependent children the family unit would continue but income would be taxed to the surviving spouse under the individual rate schedule. The continuation of the family unit on the death of one spouse would ensure that transfers of property accumulated by a couple would not be taxed on the death of the husband or of the wife.

17/ The age which we have suggested as the principal test for determining whether a child is dependent is 21. It is arguable that, since most children who do not attend university become self-sufficient before they are 21 years of age, this age should be lowered to 18 years.

18/ See reference 12 *supra.*

19/ Sections 22(1) and 22(2).

CHAPTER 11

RATES OF PERSONAL INCOME TAX

In the four preceding chapters, we have defined what the tax base should be and the units for which this tax base should be calculated. In this chapter, we recommend how taxes should be calculated for tax units having various attributes and different incomes.

For the tax system to be fair, the taxes paid by upper income tax units should be a larger proportion of their total income than the taxes paid by units with less income. If the income tax were the only tax levied, a mild progressiveness in marginal rates would suffice. However, as Chapter 6 has shown, other forms of taxation are regressive. The income tax therefore must be progressive merely to achieve a proportional tax system. To obtain a progressive tax system the income tax must be markedly progressive.

The schedules of personal income tax rates recommended in this chapter, when combined with our proposed reforms of the tax base, would increase the average progressiveness of the tax system over what it is now. The evidence supporting this contention is presented in Chapter 36. We believe this would achieve a more equitable distribution of the burden of taxation. Because the adoption of a comprehensive definition of income would increase the tax bases of upper income individuals and families more than others, this increased progressiveness could be achieved with substantially lower marginal tax rates at the upper end of the schedule. As we indicate in Chapter 37, lower marginal tax rates should make profitable investment more attractive, increase labour force participation rates and increase labour, managerial and professional effort. Lower marginal rates should consequently enhance the rate of economic growth in Canada. The fact that marginal rates could be lowered at the same time that the average progressiveness of the tax system was increased is an indication of the inefficiency of the present tax system and the need for tax reform.

CRITERIA GOVERNING THE SELECTION OF A RATE SCHEDULE

In developing the rate schedules presented in this chapter we have been guided by several objectives and constraints. Our principal objective has been to allocate taxes among tax units in proportion to each unit's ability to pay. Consequently, we have tried to devise schedules that are consistent with the criteria established in Chapter 7. In addition, we believe that the rate schedule should be consistent with the realization of the following objectives:

1. Because sales taxes are, at best, proportionate to income, and property taxes are regressive, there should be compensatory reductions in the weight of income taxes on low income tax units to achieve the allocation of all taxes according to ability to pay.

2. The weight of taxes on middle income tax units should be reduced to narrow the unfavourable income tax differential between Canada and the United States.

3. The maximum rate of tax on any form of income should be no greater than 50 per cent, to minimize disincentive effects 1/.

Only the first objective in the list is concerned with ability to pay, but we believe that the others are of sufficient importance to be taken into account in developing the rate schedules we recommend.

Our selection of rate schedules has been subject to the following constraints:

1. In accordance with the Order in Council establishing this Commission, the tax system we recommend must raise approximately the same revenue as the present tax system.

2. Apart from the industries affected by eliminating inefficient concessions in the present tax law, the weight of taxation on

equity investments should be no greater than at present, despite the widening of the tax base to include the full taxation of capital gains.

Were it not for the binding nature of the revenue constraint, it would be relatively easy to choose a rate schedule that was consistent with all of our objectives. There is no conflict among our objectives that could not be resolved by decreasing the revenue yield of the tax system. Because we are not able to reduce revenue, however, it is necessary to determine the emphasis that should be given to each objective. With some exceptions that we discuss below, primary emphasis has been placed on the first objective: making the income tax system equitable by allocating taxes in accordance with the ability to pay of tax units.

Taxation According to Ability to Pay

In Chapter 7, we concluded that taxes should be allocated in proportion to ability to pay. This result would be achieved, we believe, if the tax base was defined in accordance with our comprehensive definition of income, and if the taxes on this base were determined by schedules of rates that reflected the differences in the discretionary economic power of tax units with different incomes and different family characteristics.

The "ideal" rate schedules which we developed in accordance with the ability-to-pay principles explained in Chapter 7 are later modified to meet the other objectives and constraints. In developing these "ideal" schedules, several important assumptions have been made.

1. We assume that the first few dollars of a tax unit's income are not available for discretionary use. Below some limit, therefore, the marginal rate of tax should be zero. We have adopted a lower limit of $300 for single individuals and $700 for families. These limits, together with the other assumptions, determine the rate of progression of the marginal rates. The $300 and $700 limits would be appropriate

if personal income taxes were the only taxes levied. However, as we explain later, these limits must be increased to compensate for sales and property taxes. Accordingly, in the rate schedules we recommend, the amounts subject to a zero rate of tax are higher than these limits.

2. We assume that all income in excess of some limit is available for discretionary use. Above some limit, therefore, the marginal rate of tax on additional income should be constant. Both in arriving at our "ideal" rate schedules and the recommended rate schedules, we have accepted $100,000 as the upper limit. This limit may be excessive, even though it is only one quarter of the present limit.

3. We assume that, between these limits, equal percentage differences in income are associated with equal differences in the fraction of additional income available for discretionary use. The income brackets should, ideally, encompass equal percentage differences in income. Marginal rates should rise by equal amounts from bracket to bracket 2/.

4. Up to an income limit of $40,000 we assume that the fraction of income available for discretionary use is less for families than for individuals with the same income. Above this limit we assume that the fraction is the same for both. Consequently the rate schedule for individuals and families should merge at this point.

If these assumptions are accepted, if personal income taxes were the only taxes levied, and if equity were the only objective, the construction of rate schedules that raised sufficient revenue and allocated taxes according to ability to pay would be a straightforward, mechanical task.

Compensatory Adjustments for Other Taxes

If personal income taxes were the only taxes levied, rate schedules with the characteristics described above would, we believe, allocate taxes

according to ability to pay. Personal income taxes are not, however, the only revenue source.

Our proposed integration of personal and corporate taxes would mean that corporate source income attributable to residents would be taxed according to the ability to pay of individuals and families. But we have not recommended the integration of sales and property taxes, although we suggest that study be given to the possibility of providing arbitrary refundable tax credits against personal income tax liabilities for these taxes. Sales taxes are at best proportionate to income, and property taxes, where they are payable, decline as a proportion of income as income rises. Consequently, to allocate personal income taxes according to ability to pay, while ignoring sales and property taxes, would mean that low income tax units would be taxed too heavily relative to their ability to pay. To compensate for these non-income taxes we believe that the marginal income tax rates imposed on the first brackets should be reduced relative to what would be appropriate if personal income taxes were the only taxes.

To this end we recommend that, for unattached individuals, the first bracket should encompass the first $1,000 rather than the first $300 of income. We also recommend that this bracket should be subject to a zero rate of tax. This would be equivalent to maintaining the basic exemption of $1,000 for individuals. For families, we recommend a zero rate bracket that would encompass the first $2,100 of income. This would be slightly more generous than the present exemption for couples of $2,000.

Zero rate brackets serve exactly the same purpose, and have exactly the same consequences, as exemptions equal to the width of such brackets.

In addition to maintaining, in effect, the present exemptions, we also recommend small reductions in marginal rates at the lower end of the schedule. These measures, together with the reform of the sales tax base that we also recommend, should go some distance in moving closer to the allocation of all taxes according to ability to pay.

International Tax Comparisons

For many Canadian workers, the market for their services is continental, not Canadian. This is especially true for highly skilled and professional employees who are increasingly sought by United States and other foreign employers as well as by employers in Canada. The so-called "brain drain" from Canada has been widely noted and deplored by many observers 3/. We are anxious that the Canadian tax system should not contribute to that drain.

Taxes are not the only factor that affects an individual's decision to emigrate from Canada. For example, the persistently large differential between Canadian and United States mortgage interest rates may be as important a factor as taxes for many individuals 4/. As is emphasized in Chapter 4, differences in tax burdens are probably not as important as differences in salaries, working conditions and living costs. For reasons that need not concern us here, Canadian employers generally do not offer competitive salaries and frequently have not been able to offer work as interesting as that offered by United States employers. We are, however, concerned with reducing Canadian taxes on skilled workers and professionals to the point where there are no major tax incentives for emigration to the United States 5/.

Examples of the difference between the income taxes currently paid by taxpayers in equivalent positions in the United States and in Canada are provided in Table 11-1. This table shows, for several different situations, the total income taxes paid to all levels of government by a family with two children, both of whom are assumed to qualify for family allowances, with an income of $12,000 earned by the head of the family. Comparisons are provided for the average taxpayer earning this amount in the United States and in the Canadian provinces with the lowest tax rates, as well as for the average taxpayer residing in the State of New York and Saskatchewan. In both of the latter cases, taxes are substantially above the average for the respective countries 6/. As can be seen from the data given in the table, income taxes are higher in Canada in all examples. In fact, income taxes

TABLE 11-1

INCOME TAXES PAYABLE BY A FAMILY WITH TWO CHILDREN AND INCOME OF $12,000 IN THE UNITED STATES AND IN CANADA (1966 RATES)

United States			Canada	Percentage difference
Typical home owner				
New York State	$ 1,419	Saskatchewan	$ 1,914	-25.9
Average for United States	1,318	All provinces other than Saskatchewan, Manitoba and Quebec	1,827	-27.9
Average taxpayer filing itemized deductions				
New York State	1,529	Saskatchewan	1,914	-20.1
Average for United States	1,409	All provinces other than Saskatchewan, Manitoba and Quebec	1,827	-22.9
Average taxpayer using standard deduction				
New York State	1,843	Saskatchewan	2,178	-15.4
Average for United States	1,634	All provinces other than Saskatchewan, Manitoba and Quebec	2,060	-20.7

Note: Income taxes include provincial income taxes and old age security tax in Canada, and average state and local income taxes on the United States. They do not include compulsory contributions to government pension plans in either country. In all cases, the percentage difference is calculated using the Canadian tax figure as base.

Source: Appendix H to this Volume.

paid by a Canadian family living in the provinces with the lowest tax rates are even higher than those paid by a family residing in New York State. The differential is especially large for a family living in a house that it owns because mortgage interest payments and property taxes are deductible in computing taxable income in the United States 7/.

The examples in Table 11-1 show only the higher taxes paid by a Canadian family with two children at one income level. The percentage differences between Canadian and United States income taxes for different taxpayers with different incomes is given in Table 11-2. In all cases the comparison is between United States taxpayers with average state and local income taxes and Canadian taxpayers in provinces with the lowest income taxes. The data given in the table thus compare average United States income taxes with income taxes in all provinces other than Quebec, Manitoba and Saskatchewan. Because thirteen states in the United States do not levy any state income tax at all, this comparison is somewhat biased in favour of Canada. In spite of this bias, it is apparent from Table 11-2 that middle income taxpayers pay substantially higher taxes in Canada than in the United States. The difference in taxes arises in part from more liberal deductions in the United States, in part from lower tax rates and in part from the right of husbands and wives in the United States to file joint returns 8/.

The difference is lowest for a single individual with no dependants who does not claim itemized deductions. Such an individual, on the average, pays less income tax in the United States than in Canada if his income is between \$8,000 and \$30,000. If the United States taxpayer lives in a state such as Pennsylvania, which has no state income tax, his income taxes are less for incomes ranging from \$5,000 to \$30,000.

For a married couple, average income taxes are less in the United States if the couple's income is greater than \$7,000, even if only the standard deduction is claimed. However, over 60 per cent of United States taxable returns filed jointly by husbands and wives claim itemized deductions 9/.

TABLE 11-2

PERCENTAGE DIFFERENCES BETWEEN
UNITED STATES AND CANADIAN INCOME TAXES

Assessable Income	Percentage Difference for Single Persons, No Dependants, Using Standard Deduction	Percentage Difference for Married Couples, No Dependants, Using Standard Deduction	Percentage Difference for Family With Two Children, Itemizing Deductions
$ 1,500	76.5	-	-
2,500	34.8	249.0	-
3,500	16.2	55.4	13.4
5,000	5.2	11.6	18.4
6,500	1.5	1.8	- 18.4
8,000	- 1.3	- 3.7	- 17.3
10,000	- 4.7	- 11.9	- 19.1
12,000	- 5.6	- 15.2	- 22.9
15,000	- 6.5	- 21.5	- 27.3
25,000	- 2.4	- 28.5	- 36.6
40,000	4.5	- 23.7	- 35.0
70,000	7.2	- 14.8	- 28.1
100,000	8.5	- 10.9	- 26.7
200,000	5.3	- 6.6	- 24.3

Note: The percentages shown in this table are calculated so that a "plus" figure shows United States income taxes being higher than Canadian income taxes; a "minus" figure shows United States taxes being lower. In all cases the base of the comparison is the Canadian income tax payable on that income. United States taxes include average state income tax; Canadian taxes include only the lowest provincial income tax. Old age security taxes are included in Canadian tax figures. Compulsory contributions to government pension plans are not included in either United States or Canadian tax figures.

Source: Appendix H to this Volume.

The typical family has two children, and the taxes for such a unit appear in the third column of Table 11-2. This shows that, even including average state and local income taxes, United States income taxes are lower for such families with income over $6,000. This amount is reduced to $5,000 in a state with no state income tax. For a family with an income of $25,000, total average income taxes paid are about $2,500 less in the United States than in Canada.

Higher Canadian income tax rates might, of course, be expected if income taxes accounted for a larger share of total tax revenues in Canada than in the United States. However, the situation is actually the reverse. Even without taking into account recent increases in provincial sales taxes, in 1964 direct taxes accounted for only 45 per cent of total tax revenues of all levels of government in Canada, compared to 63 per cent in the United States 10/. The average rate of sales tax in Canada is roughly double the United States rate, and is among the highest in the world.

To reduce the relative tax advantage enjoyed by residents of the United States, we have adopted as a third objective the establishment of a rate schedule that would result in roughly equal income taxes for middle income taxpayers in Canada and in the United States. Because of the lower average income of Canadians and the higher ratio of government spending to GNP, this objective cannot be achieved completely 11/.

The Maximum Marginal Rate

If equity were the only consideration, the top personal rate of tax would be determined solely by revenue requirements. Given the size of the base and the assumed upper and lower limits between which marginal rates should vary, the top marginal rate would, in effect, be predetermined by revenue requirements.

We are persuaded that high marginal rates of tax have an adverse effect on the decision to work rather than enjoy leisure, on the decision

to save rather than consume, and on the decision to hold assets that provide monetary returns rather than assets that provide benefits in kind. We think there would be great merit in adopting a top marginal rate no greater than 50 per cent. With such a maximum marginal rate, taxpayers would be assured that at least half of all gains would be theirs after taxes. We think there is a psychological barrier to greater effort, saving and profitable investment when the state can take more than one half of the potential gain.

We recommend elsewhere that the corporate base be increased by the removal of certain concessions to some industries. Aside from this change, acceptance of the integration of personal and corporate taxes at a maximum rate no higher than 50 per cent would mean that the marginal rate of tax on income from new investments in plant and equipment would generally be reduced.

A top personal rate no greater than 50 per cent has another important advantage. With a corporate rate of 50 per cent and higher personal rates, upper income shareholders could defer personal income taxes by retaining earnings in the corporation and postponing the realization of their share gains. This would continue the existing conflict of interest between low and upper income shareholders and the lack of tax neutrality in the decision to retain or distribute corporate profits.

The Revenue Yield of the Rate Schedule

The tax system we propose must raise sufficient revenue. To ensure that this constraint is not violated, we have made an extensive analysis of the revenue-producing potential of our proposals. The results are described in Chapter 35. We are confident that the rate schedules we recommend, when taken together with our other recommendations and including transitional costs, would raise as much revenue as the present system 12/. Further reductions in the rate schedule could be made after a transitional period of a few years.

The Taxation of Income from Equity Investments

We have made a number of recommendations that should enhance the attractiveness of equity investments independently of the tax rate applicable to them. These include provisions for the more neutral treatment of income from different sources, full write-off of losses on investments and accelerated capital cost allowances for new, small businesses. The provisions should reduce the risk of equity investments and so enhance their attractiveness. Nevertheless, we believe it would be desirable to reduce marginal rates of tax on corporate source income 13/ and unwise to increase the average rates paid by residents.

The decision to undertake additional capital expenditures is presumably determined by the expected after-tax rate of return on additions to plant and equipment. Assuming that they are not shifted through lower prices or higher costs, we believe that reductions in marginal tax rates on corporate source income should stimulate equity investment. We have accepted as an objective that the rate schedules we recommend, combined with the integration of personal and corporate taxes and the full taxation of share gains, should result in a reduction in marginal rates on this kind of income for most residents.

Corporate income is a major source of saving. A higher proportion of this kind of income is saved than of other kinds of income. By holding the average rate of tax on corporate source income to no more than present levels, any adverse effects on saving of taxing capital gains should be eliminated. Consequently, we have accepted the constraint that the average burden of tax on equity investment by residents should not be increased, except for the resource industries and some financial institutions that have been too lightly taxed in the past.

RECONCILIATION OF CONFLICTING CRITERIA

Because of the revenue constraint, we have not been able to meet all our objectives in the personal income tax rate schedules we recommend.

We have set the maximum tax rate at 50 per cent, the upper limit that we are willing to accept. A higher rate would raise more revenue but result in an unacceptable increase in the weight of taxation on equity investment income and, we believe, would have appreciable disincentive effects.

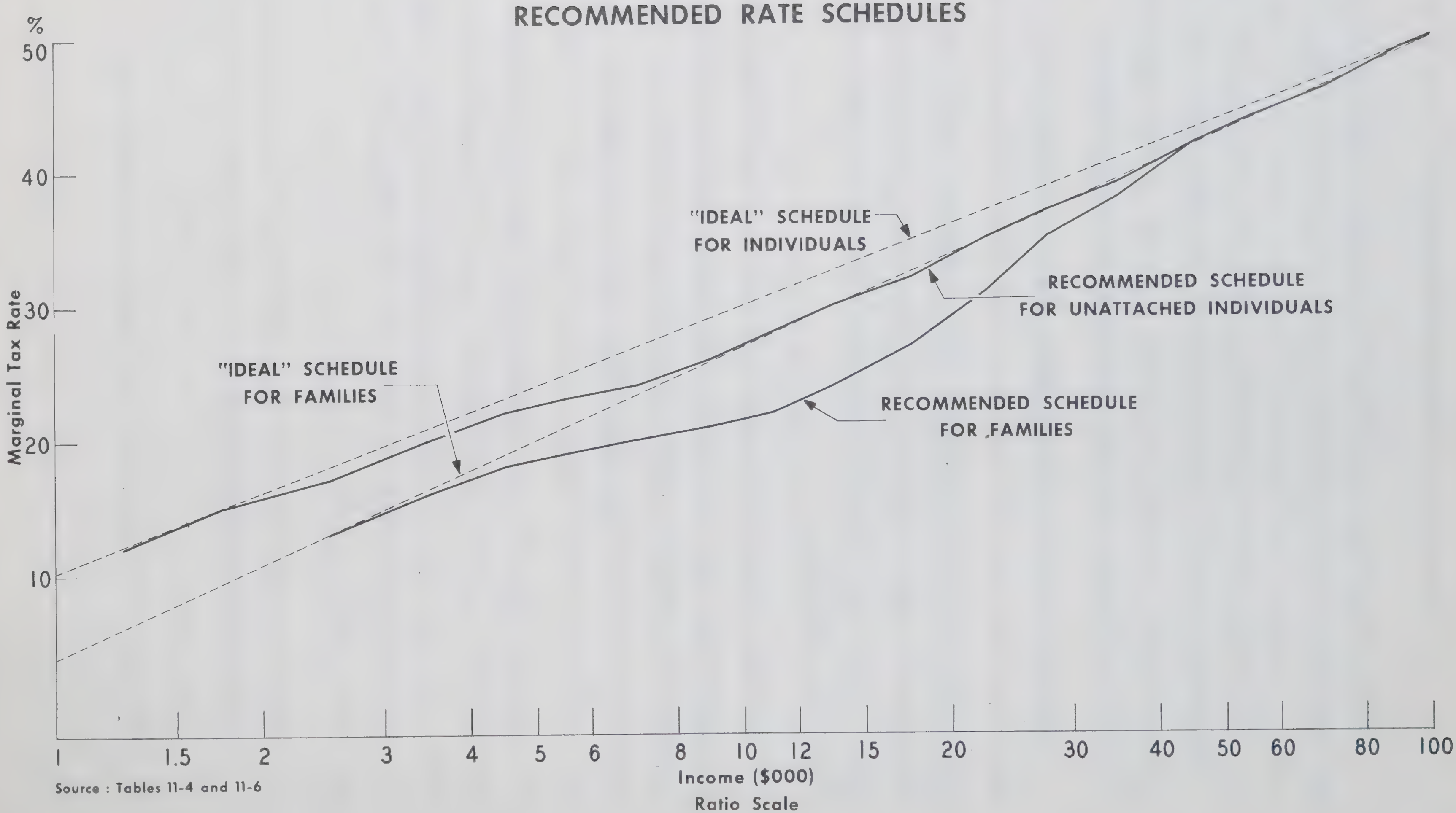
We have been able to increase progressiveness by raising the tax on upper income individuals (by broadening the tax base) and by reducing taxes at the lower end of the income scale. We have also been able to reduce taxes on middle income taxpayers so as to more closely approach United States levels. But we have not found it possible to eliminate the unfavourable differential altogether.

The rate schedules we recommend as a result of these considerations are shown in Chart 11-1. The effect of having to reconcile conflicting objectives in selecting the rate schedules is roughly illustrated by the difference between the recommended schedules shown in the chart as solid lines and the more "ideal" schedules shown as dashed lines. By "ideal" we mean consistent with all of the assumptions that would result in taxes being levied strictly in accordance with ability to pay. These assumptions are referred to earlier in this chapter and are explained more fully in Chapter 7. There are two primary differences between the rate schedules we recommend and those we regard as ideal.

1. Marginal tax rates have been reduced below ideal levels particularly on incomes between $5,000 and $40,000 to reduce taxes in middle income brackets.
2. The family rate schedule has been reduced in the middle income

Chart 11-1

RECOMMENDED RATE SCHEDULES



Source : Tables 11-4 and 11-6

> brackets to an even greater extent than the rate schedule for unattached individuals in order to bring taxes paid by middle income families closer to the income taxes which would be paid in the United States 14/.

These "distortions" have been introduced in order to obtain a rate schedule that is closer to the several objectives we have specified. As has been pointed out, our analysis has been based on what we believe to be a conservative evaluation of the revenue yield of the proposed tax system. At a later date, these distortions might be removed.

We have not included among the distortions the large amounts of income "exempted" from tax ($1,000 for individuals and $2,100 for families) under the zero brackets specified in our recommended rate schedule. These exemptions reflect considerations that cannot be overcome by the foreseeable growth in revenue, namely, the lack of progressiveness of federal, provincial and municipal sales and property taxes, which are not integrated with the income tax. However, if the weight of sales or property taxes was reduced, it would be appropriate to narrow the zero rate brackets.

The rate schedules we recommend are as consistent as seems possible with current revenue needs, with our objectives and with our other recommendations. Nevertheless, as we have emphasized before, the construction of rate schedules involves a number of assumptions which are entirely a matter of judgment. Throughout our analysis of the various component factors affecting the determination of the rate schedules, we have attempted to isolate the elements of the problem that involved judgment. We hope that in our decisions we have reflected the judgments most Canadians would make. We also hope that the framework of analysis presented in Chapter 7 and in this chapter provides an effective basis for taking into account alternative judgments in constructing rate schedules.

We turn now to a more detailed examination of the rate schedules and credits we recommend.

THE RECOMMENDED RATE SCHEDULES

We discuss the recommended rate schedules under three headings: (1) the rate schedule for individuals without dependants, (2) the rate schedule for family units and (3) the treatment of dependants. Where a family unit includes dependent children, we recommend the use of tax credits to allow for the additional non-discretionary expenses which are attributable to the children. We should emphasize that the income to which the rate schedules apply does not reflect any deduction of personal exemptions. For comparison, the current (1966) rate schedule is shown on this basis in Table 11-3. This table incorporates the old age security tax, which we believe should be eliminated as a separate tax, as well as the effect of the special reduction in rates for 1966.

The Rate Schedule for Unattached Individuals Without Dependants

The rate schedule we recommend for unattached individuals is shown in Table 11-4. Major points of similarity and of difference between this schedule and the current rate schedule are as follows:

1. The rates at which income under $8,000 is subject to tax are virtually unchanged.

2. In the current rate schedule, the increase in marginal rates accelerates rapidly after the $8,000 level. Under the recommended rate schedule, the rate of increase of the rates accelerates at a higher income level, thus reducing rates in the $8,000 - $20,000 range.

3. The maximum marginal rate in the recommended schedule is 50 per cent and is reached at an income of $100,000.

Because the top marginal rate would be reduced from 80 per cent to 50 per cent, those high income taxpayers who did not have their tax bases

TABLE 11-3

CURRENT SCHEDULE OF INCOME TAX RATES FOR INDIVIDUALS AND MARRIED COUPLES WITHOUT DEPENDANTS

Taxable Income Before Deducting Personal Exemptions	Taxes Paid By Individuals Without Dependants		Taxes Paid By Married Couples Without Dependants	
	Tax At Bottom of Bracket (dollars)	Marginal Rate (per cent)	Tax At Bottom of Bracket (dollars)	Marginal Rate (per cent)
Less than $1,000	none	—	none	—
$ 1,000 - 1,909	none	12.8	none	—
1,909 - 2,000	116	15	none	—
2,000 - 2,909	130	18	none	12.8
2,909 - 3,000	294	18	116	15
3,000 - 4,000	310	21	130	18
4,000 - 5,000	520	19	310	21
5,000 - 6,000	710	22	520	19
6,000 - 7,000	930	22	710	22
7,000 - 8,000	1,150	26	930	22
8,000 - 9,000	1,410	26	1,150	26
9,000 - 10,000	1,670	30	1,410	26
10,000 - 11,000	1,970	30	1,670	30
11,000 - 12,000	2,270	35	1,970	30
12,000 - 13,000	2,620	35	2,270	35
13,000 - 14,000	2,970	40	2,620	35
14,000 - 16,000	3,370	40	2,970	40
16,000 - 17,000	4,170	45	3,370	40
17,000 - 26,000	4,620	45	4,170	45
26,000 - 27,000	8,670	50	8,220	45
27,000 - 41,000	9,170	50	8,670	50
41,000 - 42,000	16,170	55	15,670	50
42,000 - 61,000	16,720	55	16,170	55
61,000 - 62,000	27,170	60	26,620	55
62,000 - 91,000	27,770	60	27,170	60
91,000 - 92,000	45,170	65	44,570	60
92,000 -126,000	45,820	65	45,170	65
126,000 -127,000	67,920	70	67,270	65
127,000 -226,000	68,620	70	67,920	70
226,000 -227,000	137,920	75	137,620	70
227,000 -401,000	138,670	75	137,920	75
401,000 -402,000	269,170	80	268,420	75
Over -402,000	269,970	80	269,170	80

Note: This rate schedule includes all taxes on income, including the separately calculated old age security tax of 4 per cent on the first $3,000 of taxable income. The 12.8 per cent rate on the first $909 of taxable income reflects the 20 per cent decrease up to a maximum of $20 announced in the 1966 Budget. Provincial taxes in excess of the federal abatement are not included.

TABLE 11-4

RECOMMENDED SCHEDULE OF INCOME TAX RATES
FOR AN UNATTACHED INDIVIDUAL

Taxable Income			Tax Payable			
Less than	-	$ 1,000	$		None	
$ 1,000	-	1,500			12% of income over	$ 1,000
1,500	-	2,000	60	+	15% of income over	1,500
2,000	-	3,000	135	+	17% of income over	2,000
3,000	-	4,000	305	+	20% of income over	3,000
4,000	-	5,000	505	+	22% of income over	4,000
5,000	-	6,000	725	+	23% of income over	5,000
6,000	-	8,000	955	+	24% of income over	6,000
8,000	-	10,000	1,435	+	26% of income over	8,000
10,000	-	12,000	1,955	+	28% of income over	10,000
12,000	-	15,000	2,515	+	30% of income over	12,000
15,000	-	20,000	3,415	+	32% of income over	15,000
20,000	-	25,000	5,015	+	35% of income over	20,000
25,000	-	30,000	6,765	+	37% of income over	25,000
30,000	-	40,000	8,615	+	39% of income over	30,000
40,000	-	50,000	12,515	+	42% of income over	40,000
50,000	-	60,000	16,715	+	44% of income over	50,000
60,000	-	80,000	21,115	+	46% of income over	60,000
80,000	-	100,000	30,315	+	49% of income over	80,000
Over		100,000	40,115	+	50% of income over	100,000

Note: No personal exemption is deducted in computing taxable income.

increased as a result of our other reforms would have their taxes substantially reduced. This would be particularly important for taxpayers who received large incomes primarily in the form of wages, salaries, professional income and business income. In the past, such people have generally been taxed too heavily on their incomes. Relative to the comprehensive tax base, individuals receiving income largely from investments, bequests, or other sources have not been adequately taxed. By adopting our recommendations the latter would have their taxes substantially raised, despite the lower marginal rates. The disparity in the taxes borne by high income individuals is one of the most glaring inequities of the present tax system. The broader base and lower marginal rates we recommend would eliminate this inequity.

The taxes payable by an individual at different comprehensive income levels under our proposed rate schedule are shown in Table 11-5, where they are compared to what the individual would pay under the present rate schedules in Canada and in the United States. In Table 11-5 it is assumed, for illustrative purposes, that an individual deducts only uses the optional standard deduction. Additional examples are provided in Appendix I to this Volume and in Chapter 36. The examples given in Appendix I to this Volume show the effect of our recommendations on taxpayers who have wage and salary income exclusively and claim only the standard optional deduction. The data presented in Chapter 36 show what the effect of our recommendations would have been in 1964 for all taxpayers who filed tax returns in that year.

If the tax base was unchanged, the rate schedule we recommend for unattached individuals would provide a reduction in taxes at all income levels over $10,000. Below the $10,000 level, taxes would be approximately the same as at present. Under the proposed rate schedule, Canadian taxes would be below United States levels for the top and bottom income classes. In the $6,500 - $12,000 range, Canadian taxes would be only slightly higher than United States taxes.

Because of the substantial changes in the base we recommend, these results must be interpreted with caution, however. As shown in Appendix I to this Volume, most unattached individuals who depended exclusively on employment income would have tax reductions even if their incomes were less than $10,000. Similarly, as shown in Appendix M to Volume 4, unattached individuals at the lower end of the income scale who held investments in corporate equities and relied exclusively on corporate source income would have large tax reductions.

TABLE 11-5

INCOME TAXES PAYABLE BY AN UNATTACHED INDIVIDUAL UNDER THE CURRENT RATE SCHEDULES IN CANADA AND THE UNITED STATES AND UNDER THE RECOMMENDED RATE SCHEDULE

	Income Taxes Payable		
Income	Canada (1966 Rates)	United States (1966 Rates)	Recommended Rates
$ 1,500	$ 51	$ 90	$ 54
2,500	202	267	211
3,500	394	459	395
5,000	691	727	714
6,500	1,018	1,033	1,063
8,000	1,384	1,366	1,423
10,000	1,940	1,849	1,942
12,000	2,585	2,441	2,501
15,000	3,730	3,488	3,400
25,000	8,175	7,977	6,747
40,000	15,620	16,300	12,495
70,000	32,510	34,842	25,692
100,000	50,955	55,298	40,090

Note: United States taxes include state and local income taxes of an average state; Canadian taxes include the provincial tax abatement but not provincial taxes in excess of the abatement, and the old age security tax. In all cases, it is assumed that the taxpayer claims only standard deductions. Under our recommendations, the standard deduction of $50 proposed in Chapter 12 is used.

The Rate Schedule for Family Units

The rate schedule we recommend for family units is shown in Table 11-6. This rate schedule indicates the taxes which would be payable by a married couple without dependent children. It would also be used by a couple with dependent children and, as we shall explain later, tax credits would be allowed for those children. If a family unit consisted of only one parent and one or more dependent children, this schedule would be used and no tax credit would be allowed for the first child but only for subsequent ones. Where a family unit consisted of a surviving spouse and no dependent children, this schedule would not be used, but rather the individual rate schedule.

As can be seen most clearly by referring back to Table 11-4, the principal differences between the recommended rate schedule for a family tax unit and the recommended rate schedule for an individual are as follows:

1. The entire schedule is lowered for income below $40,000, and the amount of income exempted from tax through the adoption of a zero rate bracket is increased from $1,000 to $2,100.

2. The amount of income subject to tax at marginal rates below 20 per cent is increased (i.e., from $3,000 to $6,000). To compensate, marginal rates for families are increased more rapidly than for unattached individuals at incomes above $15,000 until the $40,000 level is reached.

The effect of these differences upon the relationship between taxes paid by a single individual and by a married couple with the same income is shown in Table 11-7, which also provides comparative data for the current United States and Canadian tax rates. The present Canadian tax law provides only an additional $1,000 exemption for a married couple. Consequently, the current reduction in tax for a married couple below that of a single individual diminishes quickly as income rises. The United States federal income tax allows income splitting by a married couple, and so provides substantially

greater reductions in middle income brackets 15/. It is difficult to justify the favoured position of middle and high income married taxpayers as against that of lower income taxpayers under the United States schedule. One would expect the additional non-discretionary expenses associated with support of a wife to be a steadily decreasing proportion of income. The recommended rate schedule has been constructed to achieve this result 16/.

TABLE 11-6

RECOMMENDED SCHEDULE OF INCOME TAX RATES
FOR A FAMILY UNIT

Taxable Income			Tax Payable
Less than		$ 2,100	None
$2,100	-	3,000	13% of income over $ 2,100
3,000	-	4,000	$ 117 + 16% of income over 3,000
4,000	-	5,000	277 + 18% of income over 4,000
5,000	-	6,000	457 + 19% of income over 5,000
6,000	-	8,000	647 + 20% of income over 6,000
8,000	-	10,000	1,047 + 21% of income over 8,000
10,000	-	12,000	1,467 + 22% of income over 10,000
12,000	-	15,000	1,907 + 24% of income over 12,000
15,000	-	20,000	2,627 + 27% of income over 15,000
20,000	-	25,000	3,977 + 31% of income over 20,000
25,000	-	30,000	5,527 + 35% of income over 25,000
30,000	-	40,000	7,277 + 38% of income over 30,000
40,000	-	50,000	11,077 + 42% of income over 40,000
50,000	-	60,000	15,277 + 44% of income over 50,000
60,000	-	80,000	19,677 + 46% of income over 60,000
80,000	-	100,000	28,877 + 49% of income over 80,000
Over		$100,000	38,677 + 50% of income over 100,000

Note: No personal exemption is deducted in computing taxable income.

TABLE 11-7

PERCENTAGE REDUCTIONS IN TAXES FOR A MAN WHO MARRIES A WOMAN WITH NO INCOME UNDER THE CURRENT RATE SCHEDULES IN CANADA AND THE UNITED STATES AND UNDER THE RECOMMENDED RATE SCHEDULE

	Percentage Reductions In Taxes		
Income	Under 1966 Canadian Rates	Under 1966 United States Rates	Under the Recommended Rates
$ 1,500	100.0	96.7	100.0
2,500	74.2	33.3	76.4
3,500	48.7	31.4	51.4
5,000	27.7	23.4	37.0
6,500	21.6	21.4	30.5
8,000	18.5	20.5	27.0
10,000	15.3	21.6	25.0
12,000	13.3	22.2	24.2
15,000	10.7	25.1	23.1
25,000	5.5	30.8	18.3
40,000	3.2	29.3	11.5
70,000	1.8	22.0	5.6
100,000	1.3	19.0	3.6
200,000	0.6	11.8	1.6

Note: The figures shown are the percentage differences between taxes paid by a married couple without children and taxes paid on the same income by a single individual, using taxes of the single individual as the base of the comparison. In all cases, it is assumed that optional standard deductions are claimed. United States taxes include average state and local income taxes; Canadian taxes include the provincial tax abatement but not provincial taxes in excess of the abatement, and the old age security tax. In all cases in the United States, it is assumed that a joint return is filed.

As Table 11-7 indicates, the reduction in taxes of a married couple over those of a single individual with the same income would be larger under our recommendations than under either current Canadian or United States provisions for incomes below $12,000.

This reduction is not sufficient to reduce a married couple's taxes significantly below the total taxes of two single individuals each with half the income of the married couple, except at incomes of $3,000 or below. The relationship between taxes paid by a married couple and by two single individuals combined under the proposed rates is shown in Table 11-8, along with comparative data for the United States. As can be seen from the table, we have established the relationship between the rate schedules applicable to single and married persons to reflect our belief that the principle "two cannot live as cheaply as one, but can still live more cheaply than two people living apart" applies primarily to married couples with combined incomes in excess of $5,000. For married couples with low incomes, it is likely that the expenses of establishing a household more than outweigh other costs saved by living together. Because non-discretionary expenses upon marriage are relatively higher for taxpayers with low incomes, we recommend tax rates that reflect these higher expenses.

Because of the extent to which the family rate schedule has been lowered to reduce the tax liabilities of middle income taxpayers, the principle of increasingly "cheaper togetherness" for incomes above $5,000 is not entirely satisfied for incomes between $6,500 and $25,000.

The primary differences between the schedule presented in Table 11-6 and the 1966 Canadian rate schedule for married couples are as follows:

1. The amount of income not subject to tax (i.e., taxed at a zero rate) is increased in the proposed rate schedule by $100 and the rates at which income is taxed are considerably reduced. As a result, a married taxpayer with taxable income of $5,000

TABLE 11-8

PERCENTAGE CHANGES IN TAXES UPON MARRIAGE FOR MEN AND WOMEN WITH EQUAL INCOMES UNDER THE CURRENT RATE SCHEDULES IN CANADA AND THE UNITED STATES AND UNDER THE RECOMMENDED RATE SCHEDULE

	Percentage Changes in Taxes		
Combined Income of Husband and Wife	Under 1966 Canadian Rates	Under 1966 United States Rates	Under Recommended Rates
$ 1,500	0	0	0
2,300	-100	0	-27.3
2,400	- 50	0	-18.2
2,500	0	0	-13.3
3,000	0	0	- 2.5
3,500	0	0	1.0
5,000	0	0	3.9
6,500	0	0	5.2
8,000	0	0	3.7
10,000	0	0	1.2
12,000	0	0	-0.2
15,000	0	0	-0.1
25,000	0	0	3.7
40,000	0	0	10.4
70,000	0	0	14.9
100,000	0	0	15.7
200,000	0	0	10.5

Note: The figures shown are the percentage differences between taxes paid by a married couple without children and taxes paid by two single individuals each with half the income of the married couple. The income referred to is that of the married couple, and the taxes of the two single individuals are the standard of comparison. In all cases, it is assumed that optional standard deductions are claimed. United States taxes include average state and local income taxes; Canadian taxes include the provincial tax abatement but not provincial taxes in excess of the abatement, and the old age security tax. In all cases in the United States, it is assumed that a joint return is filed.

before deducting personal exemptions would have his taxes reduced by $51, or by more than 10 per cent.

2. The reduction in marginal rates is relatively the greatest in the middle income brackets.

3. The maximum marginal rate of 50 per cent is attained with an income of $100,000.

A comparison of taxes paid by a married couple without dependants under our recommendations with what they now pay in Canada and the United States is presented in Table 11-9.

As the data in the table indicate, taxes would be reduced substantially below 1966 rates for a middle income married couple: by $61 at an income of $6,500; by $188 at an income of $10,000; and by $715 at an income of $15,000. These reductions, of course, would apply only to taxpayers whose taxable income was unchanged by our recommendations. For such taxpayers these tax cuts would be large enough to virtually eliminate the United States-Canadian differential for married couples 17/.

Treatment of Dependants

As has been previously mentioned, we recommend the use of tax credits rather than separate rate schedules to allow for the non-discretionary expenses associated with dependent children. It might seem preferable to establish a separate rate schedule for each different family type that had different responsibilities and, therefore, different amounts of non-discretionary expenses. However, there are many differences between family responsibilities, such as the difference between families with dependent children and families with other dependants, the difference between either of these families and a tax unit supporting a student at a university or post-secondary vocational school, and the differences between otherwise similar families with school-age children where the wife is or is not working.

TABLE 11-9

INCOME TAXES PAYABLE BY A MARRIED COUPLE WITHOUT DEPENDENT CHILDREN UNDER THE CURRENT RATE SCHEDULES IN CANADA AND THE UNITED STATES AND UNDER THE RECOMMENDED RATE SCHEDULE

	Income Taxes Payable		
Income	Canada (1966 Rates)	United States (1966 Rates)	Recommended Rates
$ 1,500	$ -	$ 3	$ -
2,500	51	178	46
3,500	202	314	189
5,000	499	557	448
6,500	798	812	737
8,000	1,128	1,086	1,037
10,000	1,644	1,449	1,456
12,000	2,240	1,899	1,896
15,000	3,330	2,614	2,615
25,000	7,725	5,523	5,511
40,000	15,120	11,538	11,058
70,000	31,910	27,186	24,254
100,000	50,305	44,772	38,652

Note: United States taxes include state and local income taxes of an average state; Canadian taxes include the provincial tax abatement but not provincial taxes in excess of the abatement, and the old age security tax. In all cases, it is assumed that the taxpayer claims only standard deductions. Under our recommendations, the standard deduction of $50 proposed in Chapter 12 is used. It is assumed in all cases in the United States that an election is made to file a joint return.

Because of the many combinations of these differences, it is not administratively feasible to provide for them by establishing a separate rate schedule for each situation. Consequently, we must allow for these differences either by deductions from income or by tax credits 18/.

Under the present system, deductions are allowed under section 26 of the Income Tax Act in computing taxable income. The deduction for a child who is qualified for family allowances is $300 while the deduction for a dependent child not so qualified is $550. These deductions are frequently referred to as "personal exemptions". In addition, under the existing system, family allowances of $72 or $96 a year per child are exempt from tax. In this part of the chapter, the personal exemptions allowed for children qualified for family allowances and the exemption of family allowances, assumed to be $72 per child, are together referred to as the present exemptions.

The difference between tax credits and exemptions is simple. A tax credit involves a reduction in taxes of a given amount, while an exemption grants a reduction in taxable income. The latter results in a tax reduction that increases with income. Because an exemption excludes from tax the last dollars of income received by a taxpayer, the value of an exemption depends upon the marginal rate applicable to the taxpayer. A tax credit, on the other hand, in effect exempts a given amount of the first dollars of a taxpayer's income. A tax credit thus affects all taxpayers in the same amount, while an exemption provides an allowance which increases in value as income increases 19/. To put this in other terms, the revenue loss resulting from the use of exemptions is higher than from the use of credits, where credits and deductions achieve the same result for low income families.

We believe that the primary purpose of the additional allowances for dependants, working wives, educational support, and so forth is to reduce the tax burden on low income families whose ability to pay is most heavily affected by the additional non-discretionary expenses resulting from each of these circumstances. We therefore regard the use of tax credits as a more efficient means of achieving this objective. Accordingly, we have recommended the adoption of tax credits in place of exemptions to reflect the effect of family responsibilities upon ability to pay, and have used

the tax revenue gained from this substitution both to increase the effective allowances to low income families and to reduce marginal tax rates below what they would otherwise be.

As we explained previously in connection with the family rate schedule, a married couple with dependent children would calculate their tax liabilities under that schedule and would then deduct the tax credits allowed for their children. However, if a family unit consisted of only one parent and one or more dependent children, the same schedule would be used but no credit would be allowed for the first child. In this situation, credits would be allowed only for the second and subsequent dependent children. In the discussion which follows, it should be considered that where there is only one parent, the first child is disregarded, in effect replacing the other parent for tax purposes, and the second child would be regarded as the first child in determining the available credits.

We recommend the following credits: for the first child, \$100; and for each additional child, \$60. These credits would result in an average credit per child which decreased as the number of children increased. The average credit per child would be as follows:

One child	\$100
Two children	80
Three children	73
Four children	70
Five children	68
Eight children	65

These credits have been determined so as to make them worth more than the existing exemptions to a family with median income, all of whose children are qualified for family allowances. We acknowledge that they are low in relation to the non-discretionary expenses of raising children. However, to adopt larger credits would reduce revenues and necessitate higher marginal rates with their unfavourable effects on incentives.

The effect of the $100 tax credit for the first child in a family upon the taxes paid by the family is shown in Table 11-10. As can be seen from the data given in this table, the use of the tax credit results in a greater decrease in taxes for low income families than is provided by either the present Canadian or United States exemptions. However, the percentage decrease in taxes falls off much faster under the proposed tax credit than it does under either of the current exemptions.

TABLE 11-10

PERCENTAGE DECREASES IN TAXES FOR FAMILIES UPON THE BIRTH OF THE FIRST CHILD UNDER CURRENT RATE SCHEDULES IN CANADA AND THE UNITED STATES AND UNDER THE RECOMMENDED RATE SCHEDULE

	Percentage Decreases In Taxes		
Combined Income of Husband and Wife	Under 1966 Canadian Rates	Under 1966 United States Rates	Under Recommended Rates
$ 1,500	-	-	-
2,500	74.5	81.9	100.0
3,500	26.7	38.2	50.8
5,000	12.6	19.8	21.9
6,500	8.3	15.4	13.4
8,000	5.9	11.4	9.6
10,000	4.7	8.5	6.8
12,000	4.0	7.4	5.2
15,000	3.6	6.1	3.8
25,000	1.7	3.6	1.8
40,000	1.0	2.4	0.9
70,000	0.6	1.2	0.4
100,000	0.4	0.8	0.3

Note: Family allowances are not taken into account in this table. The effect of including family allowances can be seen from the comparison of exemptions and credits in Tables 11-12 and 11-13.

A comparison of Canadian, United States and the proposed taxes for a family with a dependent child is provided in Table 11-11. The table shows that taxes are, in all cases, substantially reduced from their present levels. At an income of $5,000, they are reduced by $75; and at an income of $10,000, by $238. However, because the United States allows a deduction of $600 for each dependent child, they are not reduced sufficiently to wipe out all differences between Canadian and United States taxes. Canadian taxes would still be higher for incomes between $6,500 and $40,000. At an income of $15,000, for instance, Canadian taxes would still be $182 higher than United States taxes. This gap would be partially offset by family allowances.

The credits that we propose for dependants are equivalent to a liberalization of exemptions for lower income families and a tightening for upper income families. For families with income under a certain level, the proposed system of credits would reduce taxes from what they would be with current personal exemptions. For families with higher income, the effect would be the reverse. The "break-even" level for families in each income group would depend on the number of children in the family. This is shown in Table 11-12.

A more precise indication of the effect of substituting tax credits for personal exemptions is provided by Table 11-13. This shows the personal exemptions required to yield the same tax as the set of tax credits we propose with the proposed rate schedule. As can be seen by comparing the figures in Table 11-13 with the current personal exemptions listed in Table 11-12, the use of tax credits results in a substantial reduction of taxes for low income families. Indeed, the proposed rate schedule and tax credit system would remove the obligation to pay income taxes from many low income families with children.

TABLE 11-11

INCOME TAXES PAYABLE BY A FAMILY WITH ONE CHILD UNDER CURRENT RATE SCHEDULES IN CANADA AND THE UNITED STATES AND UNDER THE RECOMMENDED RATE SCHEDULE

	Income Taxes Payable		
Taxable Income	Canada (1966 Rates)	United States (1966 Rates)	Recommended Rates
$ 1,500	$ -	$ -	$ -
2,500	13	28	-
3,500	148	170	101
5,000	436	402	361
6,500	732	629	651
8,000	1,062	886	952
10,000	1,566	1,228	1,372
12,000	2,150	1,644	1,812
15,000	3,210	2,310	2,533
25,000	7,590	5,084	5,435
40,000	14,970	10,880	10,986
70,000	31,730	26,180	24,187
100,000	50,110	43,500	38,588

Note: As in Table 11-5, it is assumed that all taxpayers claim only the optional standard deduction. Family allowances are not included in taxable income shown on the stub of the table but are added to taxable income to arrive at the figures reported as taxes payable under the recommended rate schedule. United States taxes include average state and local income taxes; Canadian taxes include the provincial tax abatement but not provincial taxes in excess of the abatement, and the old age security tax.

TABLE 11-12

INCOME AT WHICH THE PROPOSED TAX CREDITS FOR ADDITIONAL DEPENDENT CHILDREN RESULT IN THE SAME AMOUNT OF TAX AS PRESENT EXEMPTIONS

Number of Children in Family	Total Exemptions for Children Under Present Law, Including Exempt Income From Family Allowances	Proposed Credits	Income at Which Credits and the Present Exemptions Both Yield the Same Tax
1	$ 372	$100	$15,360
2	744	160	10,365
3	1,116	220	6,786
5	1,860	340	5,744
8	2,976	520	5,885

Note: Family allowances of $72 a year are assumed to be payable in respect of each child, and accordingly, under the current law, a $300 exemption for each child would be available. Taxes are computed using the proposed family rate schedule.

Many low income taxpayers are, we believe, now being unfairly taxed. Under the present system of exemptions as applied under the proposed rate schedule, the dependent exemption of $600 now allowed for a family with two children, plus the exemption of family allowances, would be worth $162 to a family with an income of $12,000. They would be worth only $98 to a family with an income of $3,000. Only if it is assumed that the responsibilities of raising children are less onerous for low income families than for higher income families can such a disparity be justified.

TABLE 11-13

THE MAGNITUDE OF EXEMPTIONS EQUIVALENT
TO RECOMMENDED CREDITS FOR CHILDREN

Taxable Income	Number of Children in Family 1	2	3	5	8
$ 2,500	$ 400*	$ 400*	$ 400*	$ 400*	$ 400*
3,500	654	1,115	1,400*	1,400*	1,400*
5,000	556	889	1,250	2,000	2,900*
6,500	500	816	1,132	1,778	2,812
8,000	500	800	1,100	1,700	2,632
10,000	476	762	1,048	1,619	2,500
12,000	454	727	1,000	1,545	2,381
15,000	417	667	917	1,417	2,167
25,000	323	516	710	1,097	1,677
40,000	263	421	579	895	1,368
70,000	217	348	478	739	1,130
100,000	204	327	449	694	1,061

Note: An asterisk indicates that the recommended credit is more than sufficient to eliminate the tax liability. The figure shown in such cases is the total amount of income which would have been taxed were it not for the tax credit.

A comparison of Canadian, United States and the proposed rates for a family with two dependent children is shown in Table 11-14. As noted before, a majority of United States families, and substantially more than a majority of families with children, claim itemized deductions. The comparisons in Table 11-14 are based upon average deductions claimed by United States taxpayers who itemize 20/.

As can be seen from Table 11-14, adoption of the recommended rate schedule and credits would result in a substantial reduction of taxes for all taxpayers. Tax reductions would be on the order of $60 to $85 for incomes between $5,000 and $8,000 and from $130 to $500 for incomes between $10,000 and $15,000. For incomes over $6,000, Canadian taxes would be higher than those of the United States. For a family earning $25,000, for instance, taxes under our recommendations would be $616 higher than in the United States. Removal of this higher tax should be an objective of any future tax reductions.

ADDITIONAL CONSIDERATIONS

Additional considerations affecting the rate schedules arise because of three factors:

1. The aggregation of incomes of members of a family resulting from adopting the family as the tax unit.
2. An allowance for the additional non-discretionary expenditures of a family with dependent children in which both spouses are working.
3. Flexibility in the rate schedules to allow for tax rates to be changed for countercyclical fiscal policy.

Multiple Income Recipients

Aggregation of incomes of members of a family results in higher taxes being paid by that family, provided that the same rate schedule is applicable to the amounts being taxed in each way. Suppose for instance that a husband and wife each had a comprehensive tax base of $5,000 including family allowances, and that each, as an individual taxpayer, could claim support of a dependent child. Both could then file as married persons under the current law.

TABLE 11-14

INCOME TAXES PAYABLE BY A FAMILY WITH TWO CHILDREN
FILING AVERAGE ITEMIZED DEDUCTIONS UNDER
CURRENT RATE SCHEDULES IN CANADA AND THE UNITED STATES
AND UNDER THE RECOMMENDED RATE SCHEDULE

	Income Taxes Payable		
Income	Canada (1966 Rates)	United States (1966 Rates)	Recommended Rates
$ 1,500	$ -	$ 3	$ -
2,500	-	23	-
3,500	67	76	1
5,000	294	348	235
6,500	586	478	505
8,000	865	715	779
10,000	1,316	1,065	1,185
12,000	1,827	1,409	1,586
15,000	2,744	1,996	2,251
25,000	6,758	4,284	4,900
40,000	13,666	8,886	10,056
70,000	29,362	21,117	22,460
100,000	46,571	34,145	36,018

Note: Itemized deductions under the current Canadian and United States tax laws are the average deductions shown in Appendix H to this Volume. Itemized deductions under our recommendations are assumed to be the same as the average deductions under current Canadian tax law. United States taxes include average state and local income taxes. Canadian taxes include the provincial tax abatement but not provincial taxes in excess of the abatement, and the old age security tax.

If they were allowed to file separately, using the family rate, their taxes under the proposed rate schedule, if they took a standard deduction, would amount to $448 each, or $896 taken together. With incomes aggregated, the couple would file as a family with two children and their taxes would be increased to $1,296.

Aggregation, while equitable, may increase taxes over what they would otherwise be. It thus raises two potential problems:

1. An enforcement problem which would arise from the advantage for families that were able to avoid aggregating.

2. An incentive problem, which would arise from the effect of higher marginal rates upon the after-tax compensation received by working wives 21/.

To deal with the first problem, we have proposed in Chapter 10 that the taxes of husbands and wives filing separately be calculated in a manner that would ensure that their taxes would generally be higher, and never lower, than if they filed a joint family return. We recommend that all standard deductions and limitations on itemized deductions claimed by each taxpayer be reduced by one half for spouses filing separately, and that each spouse then calculate his or her tax liability by doubling taxable income and applying to that figure the rate schedule for family units, and then reduce the resultant tax liability by one half.

The second problem has been taken into consideration in setting the relationship between the individual and family rate schedules and by the tax credits for working mothers that we shall recommend.

Because the family rate schedule that we recommend involves a reasonably large reduction at most income levels from the rate for single individuals, the tax increase that would result from aggregation if there were no change in the applicable rate is, in most cases, more than offset by moving

to the lower schedule. For instance, if a husband and wife with no children had incomes of $8,000 and $2,000 respectively, their taxes under the proposed rate schedule for single individuals would be $1,435 and $135 respectively, or $1,570 in total, ignoring standard deductions. If they filed as an aggregated family unit, their taxes would be reduced to $1,467.

A summary of the effect of aggregating the incomes of two taxpayers filing separate returns is shown in Table 11-15 for different total family incomes and three different percentages of income accounted for by the wife. This table essentially shows the amounts of "marriage tax" or "marriage tax saving" which would result under our proposed rate schedules when two taxpayers receiving income married and both continued to receive the same income. As can be seen from the table, there would be either a tax saving or very little additional tax for families with incomes of $15,000 or less.

The effects of aggregation on incentives are most clearly seen by examining the effective tax rates applicable to income earned by the wife. These rates are presented for different combinations of husbands' and wives' incomes in Table 11-16, where they are compared with the effective rates of tax now being paid by a working wife. As can be seen from the table, these effective rates are very much dependent upon the husband's income. This is also the case under the present tax law, simply because the $1,000 exemption which the husband gives up through his wife's working is worth more if the husband's income is higher. Because the loss to the husband is complete once a wife earns more than $1,250, the effect of the partial aggregation existing in the present system diminishes as the wife's income increases.

Because aggregation is complete under the proposed tax system, rather than partial as it is under the existing system, the effect of aggregation by itself is more pronounced. Nevertheless, because marginal rates under the rate schedule for married couples are so much lower than at present, the effective tax rates applicable to a wife's income are not increased

TABLE 11-15

CHANGE IN TAX RESULTING FROM THE AGGREGATION OF INCOME OF HUSBANDS AND WIVES WHO WOULD OTHERWISE BE TAXED AS SINGLE

Total Taxable Income of Husband and Wife	Additional Tax: 20 Per Cent of Income Received By Wife	Additional Tax: 35 Per Cent of Income Received By Wife	Additional Tax: 50 Per Cent of Income Received By Wife
$ 1,500	$ -24	$ -	$ -
2,500	-83	-27	-8
3,500	-74	-12	2
5,000	-48	4	17
6,500	-60	11	37
8,000	-79	5	37
10,000	-103	-13	17
12,000	-147	-29	-3
15,000	-193	-46	-3
25,000	-213	82	197
40,000	247	827	1,047
70,000	1,807	2,862	3,147
100,000	3,347	4,697	5,247

Note: Minus figures indicate a tax saving on marriage. Positive figures indicate a "marriage tax". Standard deductions are not taken into account.

TABLE 11-16

EFFECTIVE TAX RATES ON WAGE AND SALARY INCOME EARNED BY A WIFE UNDER THE CURRENT AND RECOMMENDED RATE SCHEDULES

Income of Husband	Income of Wife: $1,500 Current	$1,500 Proposed	$2,500 Current	$2,500 Proposed	$3,500 Current	$3,500 Proposed	$5,000 Current	$5,000 Proposed
$ 1,500	.068	.066	.101	.100	.127	.120	.148	.140
2,500	.135	.143	.141	.154	.156	.162	.168	.171
3,500	.162	.166	.158	.172	.167	.178	.177	.183
5,000	.162	.185	.158	.188	.167	.191	.177	.194
6,500	.181	.194	.169	.197	.175	.199	.182	.202
8,000	.205	.202	.183	.203	.186	.206	.189	.210
10,000	.231	.211	.199	.213	.197	.218	.197	.223
12,000	.264	.227	.219	.230	.211	.230	.207	.240
15,000	.301	.252	.241	.259	.227	.262	.218	.264
25,000	.334	.335	.261	.341	.241	.344	.228	.346
40,000	.367	.405	.281	.411	.255	.414	.238	.416
70,000	.434	.460	.321	.460	.284	.460	.258	.460
100,000	.467	.496	.341	.498	.298	.498	.268	.499

Note: The effective tax rate applicable to a wife's income is the ratio between the additional tax paid as a result of the wife's working and the additional income received by the wife. It is assumed that all income is from wages and salaries, that there are no children in the family unit, and that only standard deductions are claimed.

materially except when the combined income of husband and wife is substantial. We would consequently expect that there would be little disincentive effect on working wives' participation in the labour market as a result of aggregating family incomes.

Allowances for Working Mothers

When wives work, some additional family housekeeping expenses may result, but it is unlikely that a significant portion of such added expenses is non-discretionary for a family with no children 22/. However, for a family with children, additional non-discretionary expenses clearly arise when both parents work.

As with other allowances which are not built into the rate schedule, it is possible to make arbitrary allowances which adjust tax payments so as to reflect a different ability to pay. The additional expenses associated with the care of children, when both husband and wife work, are highly variable. We recommend allowances that attempt to reflect these expenses. Because they are greatest when children are below school age, the allowance should take into account the age of the children in the family.

It is desirable to focus the impact of these allowances on lower income taxpayers whose relative ability to pay is most heavily affected by non-discretionary expenses, and we recommend that these allowances be made as tax credits. Specifically, our recommendations are as follows:

1. A tax credit of $80 should be allowed to any family unit containing one or more children receiving family allowances in which both husband and wife were engaged in employment or in carrying on a business for more than 120 days a year 23/.

2. An additional tax credit of $120 should be allowed to such a family unit if it contained a child under the age of seven.

These credits are roughly equivalent to additional exemptions of $400 and $600 respectively for a family with an income of $7,000. They may also be regarded as equivalent to an assumed non-discretionary expense of $400 for a family with pre-school children and $160 for a family with school-age children but no pre-school children 24/. Their impact is, of course, relatively greater for families with lower incomes.

The effect of these allowances upon the income of working mothers can be seen by examining Table 11-17, which presents data on the effective tax rates under our proposals on different incomes earned by working mothers. From a comparison of Table 11-17 with the current tax rates shown in Table 11-16, it is evident that effective tax rates would be substantially reduced below current rates for families with total incomes ranging as high as $15,000. Though the primary reason for recommending credits for working mothers is to reflect a changed ability to pay of the family, the credits would encourage female participation in the labour force.

Future Tax Reductions

In selecting the rate schedules, we have been unable to meet some of our objectives fully because of the necessity of raising sufficient revenue. As per capita incomes increase, the tax system we propose should yield a greater flow of tax revenues than would be required to meet government expenditures if these expenditures grow no faster than they have in the past. Quite beyond this, a substantially greater amount of revenue will be yielded by our rate schedule after an initial transitional period has elapsed. We have pointed out in Chapter 3 that the resultant revenue drag can be offset in a number of ways. To the extent that it is decided to offset this drag by reducing taxes, we strongly recommend that such reductions be designed to bring the tax system more into line with our objectives. This could be achieved to varying degrees through any of the following:

1. Reducing all marginal income tax rates in the same proportion.
2. Reducing further the marginal income tax rates levied in middle income brackets.

TABLE 11-17

EFFECTIVE TAX RATES ON WAGE AND SALARY INCOME
EARNED BY A MOTHER OF SCHOOL-AGE CHILDREN
UNDER THE RECOMMENDED RATE SCHEDULE

Income of Husband	Income of Wife: $1,500	$2,500	$3,500	$5,000
$ 1,500	—	.028	.069	.104
2,500	.047	.096	.121	.142
3,500	.113	.140	.155	.167
5,000	.131	.157	.168	.178
6,000	.141	.165	.176	.186
8,000	.148	.171	.183	.194
10,000	.158	.181	.196	.207
12,000	.174	.198	.208	.224
15,000	.199	.227	.239	.248
25,000	.282	.309	.321	.330
40,000	.352	.379	.391	.400
70,000	.407	.428	.437	.444
100,000	.443	.466	.476	.483

Note: The effective rate of tax on a wife's income is the ratio between the additional tax paid as a result of the wife's working and the additional income received by the wife. It is assumed that all income is from wages and salaries and that only standard deductions are claimed. Taxes of the family unit are reduced by the $80 credit for a family with both spouses working and with children under 16, but not by the additional $120 credit for families with both spouses working and with children under 7.

3. Reducing marginal income tax rates at the bottom and top of the income scale while keeping middle rates unchanged to make the schedules more consistent with our ability-to-pay principles.

4. Providing additional tax credits for individuals and families to counter the regressiveness of sales and property taxes levied by all levels of government.

5. Reducing the federal sales tax rate.

The first two types of tax reductions would have the most favourable economic effect. Reducing marginal tax rates in middle and upper brackets would lower taxes on new investments made by Canadian residents and so would enhance the profitability of capital expenditures and increase the growth rate of the Canadian economy. In addition, both types of tax reduction would benefit middle income individuals and families, and so, by making Canadian-United States tax comparisons more favourable to Canada, would help retard the emigration of skilled workers and professionals.

But neither of the first two types of tax reduction would improve the equity of the tax system. Indeed, if marginal middle income rates deviated even more from the rates consistent with ability-to-pay principles, the tax system would be less equitable.

The third alternative would have almost as favourable an effect as the first two upon new equity investments made by Canadian residents, and would increase the equity of the system. By reducing marginal rates sufficiently, so that these rates would rise proportionately with percentage changes in income, it would be possible to make the income tax fully consistent with the ability-to-pay principles stated in Chapter 7.

The last two alternative tax reductions would have the least favourable effect on economic growth, but would increase the equity of the system.

There is, in general, a conflict between increasing the equity of the tax system and making the tax system more conducive to economic growth. In recommending the rate schedules specified in this chapter, we have been able both to increase equity and increase incentives. This is possible because the present system is inefficient.

In any future tax reduction, the specific types of reductions chosen would have to reflect a decision as to the relative importance of further increases in the equity of the tax system or in incentives for the encouragement of investment and effort. Other than to specify the range of alternatives consistent with the objectives specified in this chapter, we do not make a recommendation as to which of the alternatives should be chosen.

Short-Term Adjustments to the Rate Schedule

We have suggested how the rate schedule could be changed as long-term growth in revenue permitted. In addition to such long-term changes, it will be necessary to raise or lower the revenue yield of the system for short periods of time for stabilization purposes. We recommend that this be done simply by multiplying the tax liability of each individual by a factor chosen to increase or decrease all taxpayers' tax liabilities by the same percentage amount.

Our main concern in devising a rate schedule has not been to present an "ideal" set of rates, but rather to achieve a suitable progression within the rate schedules. More importance should be attached to the ranking contained in our suggested schedules than to the absolute figures or to the total revenue yield. With the progression of the rate schedules established, the total revenue could be varied by changing the level of the whole schedule. The most important change we recommend is not a change in rates but a change in progression.

CONCLUSIONS AND RECOMMENDATIONS

SELECTING RATE SCHEDULES WHICH RESULT IN TAXATION ACCORDING TO ABILITY TO PAY

1. Our primary objective in specifying the rate schedules we recommend is to make taxes paid by individuals and families with different incomes and with different responsibilities proportionate to their ability to pay. It is first necessary to construct a rate schedule to meet this objective before modifying it to take account of other objectives and constraints.

2. The principles governing the specification of rate schedules which would result in taxation according to ability to pay were described in Chapter 7. To construct a rate schedule in accordance with these principles, it is necessary to:

   a) Decide upon the upper and lower limits to the range over which the proportion of income available for discretionary use varies.

   b) Select the basic tax rate (or rate of tax on discretionary income) that yields the desired amount of revenue. This will be the maximum marginal rate which is applicable to income above the upper limit.

   c) Select intervening tax brackets between the lower and upper limits that cover roughly equal percentage changes in income.

   d) Select intervening tax rates that increase equally between zero and the maximum rate and apply these rates to the intervening brackets.

3. It is clear from these rules that the major judgment in constructing a rate schedule in accordance with ability-to-pay principles is in deciding upon the upper and lower limits of the range of income over which some, but not all, of each dollar of additional income is available for discretionary use. Once this is done, the relationship among rates follows from our ability-to-pay principles.

4. For unattached individuals, we have arbitrarily assumed an upper limit of $100,000 and a lower limit of $300. This gives the range over which marginal rates should vary if the impact of sales and property taxes were not to be considered.

5. For family tax units we have assumed an upper limit of $100,000 and a lower limit of $700. We have also assumed that, of income below $40,000, the proportion available for discretionary use is less for family units than for unattached individuals, and that the proportion of income in excess of $40,000 which is available for such use is the same for both family units and individuals. Tax credits are recommended to reflect the responsibilities of raising children.

COMPARISONS OF TAXES IN CANADA
AND THE UNITED STATES

6. For a typical family that itemizes deductions and supports 2 children, income taxes are roughly 20 per cent lower in the United States than in Canada on incomes over $6,000.

7. Other taxes are a higher proportion of income in Canada than in the United States. The average rate of sales tax in Canada is roughly double the average rate in the United States.

8. Because these differences can affect an individual's choice between working in Canada and working in the United States, we believe it is important that they be made less unfavourable to Canada.

OTHER CONSIDERATIONS AFFECTING THE
SELECTION OF RATE SCHEDULES

9. Because of the regressive incidence of taxes other than income taxes, the weight of income taxes should be reduced on low income tax units relative to what would be appropriate if these other taxes did not exist. Consequently, we recommend maintaining the present exemptions roughly at current levels through the adoption of zero rate brackets of $1,000 and $2,100 for individuals and family units respectively.

10. To reflect the difference between Canadian and United States tax burdens on middle income families, taxes should be reduced for middle income taxpayers.

11. To reduce the disincentive effects of high marginal rates which could not be avoided, the maximum marginal tax rate should be held down to 50 per cent.

12. Apart from the effect of eliminating inequitable concessions to a few industries, the weight of tax on equity investments owned by Canadian residents should not be increased over present levels.

REVENUE REQUIREMENTS

13. In accordance with the instructions given to us in defining our terms of reference, we have specified a rate schedule which, when taken together with our other reforms, would raise as much revenue as the present tax system.

14. It has not been possible to raise enough revenue and at the same time meet all of our objectives. We have consequently had to decide which objectives to compromise.

15. In order to make substantial reductions for middle income taxpayers, tax rates in middle income brackets have been reduced below the levels which would be implied by a 50 per cent top rate together with appropriate progressiveness. In spite of this, we have not been able to overcome completely the gap between Canadian and United States taxes for all middle income taxpayers.

16. Tax reductions in lower income brackets result from combining the rate schedules having a 50 per cent top rate and based on ability-to-pay principles with the current levels of exemptions for individuals and families, in order to allow for the regressive incidence of property taxes and the regressive, or at least non-progressive, incidence of sales taxes.

THE RECOMMENDED RATE SCHEDULES

17. The rate schedules we recommend are shown in Table 11-18.

18. In addition, we recommend that the following tax credits be allowed:

For the first child (or the second child if there is only one parent in the family unit)	$100
For each additional child	60
For a working mother with school-age children	80
For a working mother with pre-school children	200

19. The rate schedule for unattached individuals would result in modest tax increases for individuals at the bottom of the scale whose taxable income would not be increased by our other reforms. The reductions for the middle income brackets would eliminate most of the unfavourable differences between United States and Canadian income taxes for single individuals.

TABLE 11-18

RECOMMENDED RATE SCHEDULES

Taxable Income	Unattached Individuals: Tax at Bottom of Bracket	Unattached Individuals: Marginal Tax Rate on Income In Bracket	Family Units: Tax at Bottom of Bracket	Family Units: Marginal Tax Rate on Income In Bracket
	$	%	$	%
Less than $ 1,000	None	—	None	—
$ 1,000 - 1,500	None	12	None	—
1,500 - 2,000	60	15	None	—
2,000 - 2,100	135	17	None	—
2,100 - 3,000	152	17	None	13
3,000 - 4,000	305	20	117	16
4,000 - 5,000	505	22	277	18
5,000 - 6,000	725	23	457	19
6,000 - 8,000	955	24	647	20
8,000 - 10,000	1,435	26	1,047	21
10,000 - 12,000	1,955	28	1,467	22
12,000 - 15,000	2,515	30	1,907	24
15,000 - 20,000	3,415	32	2,627	27
20,000 - 25,000	5,015	35	3,977	31
25,000 - 30,000	6,765	37	5,527	35
30,000 - 40,000	8,615	39	7,277	38
40,000 - 50,000	12,515	42	11,077	42
50,000 - 60,000	16,715	44	15,277	44
60,000 - 80,000	21,115	46	19,677	46
80,000 - 100,000	30,315	49	28,877	49
Over 100,000	40,115	50	38,677	50

20. The rate schedule for family units would result in tax reductions at all levels of income. The reductions would be sufficient to make Canadian income taxes lower than United States income taxes at lower and higher income levels and approximately equal to United States income taxes at middle income levels for married couples without children whose taxable income was unchanged by our other reforms.

21. When combined with the tax credits we have recommended, the family rate schedule would result in a substantial decrease in taxes for most families with dependent children. However, the reduction would be insufficient to reduce Canadian taxes below United States income taxes for most such families.

THE EFFECT OF THE RECOMMENDED RATE SCHEDULES UPON THE PROGRESSIVENESS OF THE TAX SYSTEM

22. When combined with all the other reforms we have recommended, the effect of the rate schedule in this chapter would be to increase substantially the progressiveness of the tax system. Because this increased progressiveness would result from a comprehensive definition of income, this increase in progressiveness would be achieved with a schedule which reduced marginal tax rates at most levels of income. This reduction in marginal rates should result in greater incentives for the expenditure of effort and for the profitable investment of capital.

23. We recommend that in determining the method of implementing any future tax reductions, consideration should be given to the objectives which we have not been able to achieve fully because of the necessity to maintain present revenues. Any combination of the following changes would assist in the realization of one or more of these objectives:

a) Reducing all marginal income tax rates proportionately.

b) Reducing further the marginal income tax rates levied at middle income brackets.

c) Reducing marginal income tax rates by varying amounts to make them more fully in accord with our ability-to-pay principles.

d) Providing additional tax credits for individuals and families to counter the regressiveness of sales and property taxes levied at all levels of government.

e) Reducing the federal sales tax rate.

The first two would have the most favourable economic effect, while the last three would improve the equity of the system.

REFERENCES

1/ If we were concerned only with ability to pay, we would recommend that the top marginal rate of tax be made equal to the rate of tax on the income available for discretionary purposes. This rate would be determined by the size of the base and revenue requirements. This additional objective reflects economic considerations.

2/ Setting the rate schedule in this way can be facilitated by using semi-logarithmic paper to plot the marginal tax rates against the logarithm of income, because equal changes in the logarithm of income are equivalent to equal percentage changes in income. Using semi-logarithmic paper, a rate schedule can be constructed in accordance with ability-to-pay principles by simply drawing a line between a zero rate at the lower income limit and a given maximum rate at the upper income limit. By varying the maximum rate, and hence the slope of the line relating marginal rates to income, different amounts of revenue can be obtained from the same tax base.

3/ See, for instance, the First Annual Report of the Economic Council of Canada. As we have noted in Chapter 4, the net emigration of professionals and skilled workers is partially offset by a net immigration of such individuals from Europe and from other areas. However, it should be emphasized that the offset is only partial and that the loss is important whether or not it is offset.

4/ Interest costs on a conventional home mortgage have been 15 per cent to 20 per cent higher in Canada than in the United States in recent years. United States Federal Reserve Bulletin, July 1966, and Report of the Royal Commission on Banking and Finance, p. 281.

5/ In this context, we have not concerned ourselves with tax comparisons with European or other countries because the opportunities for emigration are few. The direct and indirect moving costs are obviously much higher in the case of moving outside North America, and consequently, the labour market is, for the most part, continental rather than global. The relevant factors are mostly favourable to Canada as compared with countries other than the United States.

6/ Supporting data for all statements about United States taxes are provided in Appendix H to this Volume.

7/ As we point out in Chapter 8, we do not believe that mortgage interest and property taxes should be deductible, because the allowance of these items discriminates against the individual who rents his living accommodation. Our point here is that these deductions result in income taxes being lower than they would otherwise be for many families in the United States and so further increase the gap between United States and Canadian income tax burdens on middle income families.

8/ In addition, the difference is increased for families with children by the greater exemptions allowed for dependent children.

9/ Deductions were itemized on 26.5 million United States tax returns in 1962. Of these, 19.1 million returns were taxable joint returns of husbands and wives. Statistics of Income, 1962: Individual Income Tax Returns, Washington; Internal Revenue Service, 1965, Table 13.

10/ "Direct taxes" in this context include personal and corporate income taxes, taxes on gifts and bequests, and social security taxes. This definition is slightly broader than that used in the remainder of this chapter, where compulsory contributions to government pension plans are included in indirect taxes. The United States figure

includes the effects of the March 1964 income tax reduction that cut personal and corporate income taxes by 16 per cent. Data are from Dominion Bureau of Statistics, National Accounts, 1964, Table 36, and O. Eckstein, "Comparison of European and U.S. Tax Structures and Growth Implications", in the Role of Direct and Indirect Taxes in the Federal Revenue System, Princeton; Princeton University Press, 1964, p. 221. It is of interest to note that direct taxes account for between 51 per cent and 59 per cent of total taxes of all levels of government in France, Germany, Italy and the United Kingdom.

11/ Expenditures per capita by all levels of government are only 10 per cent lower in Canada than in the United States, even though GNP per capita is about 25 per cent lower. If defence expenditures are excluded per capita government expenditures are actually higher in Canada. Consequently, taxes must be a higher fraction of Canadian GNP. In addition, the lower average incomes of Canadian taxpayers result in a higher proportion of taxable income being at the low end of the rate schedule. Less than 4 per cent of Canadian taxpayers had incomes in excess of $10,000 in 1964, compared to more than 10 per cent in the United States. Because of the lower incomes of Canadian taxpayers, any rate schedule with progressive rates will result in a smaller fraction of total income being taxed in Canada than in the United States. To raise the same amount per capita through income taxes in both countries would require higher tax rates in Canada.

12/ In setting the rates, we have limited ourselves to providing as much revenue as was produced by the tax system in 1964, the most recent year for which detailed data are available. This is a conservative estimate of the amount of revenue which we believe the proposed rates would raise.

13/ The term "corporate source income" is intended to include dividends, retained earnings and goodwill gains in the value of shares.

14/ This reduction has had the effect of making the relationship between the tax rates applicable to individuals and families differ slightly from what would be consistent with our ability-to-pay principles. However, the deviation is sufficiently minor to be ignored.

15/ The United States figures shown in Table 11-7 include state and local income taxes. Excluding state and local taxes makes little difference to these figures except at the lower levels of income: the reduction in taxes is then 58.0 per cent at $1,500; 17.9 per cent at $6,500; 30.7 per cent at $25,000; and 18.9 per cent at $100,000.

16/ Our comments should not be taken as overly critical of existing rate schedules. The interacting elements of a rate schedule, associated concessionary allowances and changes in the tax base make it difficult to construct a schedule which adequately reflects all the various objectives considered. We have been able to do so only as a result of having developed a computer programme which could, for any rate schedule, quickly calculate the tables presented in this chapter, in Chapters 35 and 36, and in Appendix I to Volume 3 and Appendices M and N to Volume 4. Over 30 variants of the recommended schedule were analyzed under this programme before the final version was arrived at.

17/ It should be emphasized that the comparisons presented in Table 11-9 are made on the assumption that taxpayers claim only the standard deductions. As can be seen from the data contained in Appendix H to this Volume the range of incomes for which Canadian taxes would be lower than United States taxes is decreased if comparisons are based on average deductions claimed by taxpayers. United States taxes would also be lower than those shown in the table for taxpayers

having property gains, because such gains are taxable in the United States at preferential rates. On the other hand, the United States does not integrate the corporate tax with the personal tax and, accordingly, Canadian taxes under our proposals would be relatively lower for taxpayers receiving corporate distributions.

18/ If it were administratively feasible to have any number of rate schedules, the need for either credits or exemptions would disappear. The effects of any credit or exemption can be fully incorporated in a rate schedule. For instance, the rate schedule for individuals shown in Table 11-4 yields exactly the same taxes for all individuals as the combination of a $1,000 exemption and a rate schedule formed by deducting $1,000 from the limits of each taxable income bracket. Likewise, the schedule in Table 11-4 yields taxes which are identical to those calculated by applying a tax credit of $100 to a gross tax calculated from a rate schedule formed by taxing income under $1,000 at 10 per cent and adding $100 to the taxes at each bracket shown in Table 11-4. One can make up a rate schedule which, when combined with a given tax credit, yields the same taxes as another rate schedule for any given tax credit. For instance, by putting a 200 per cent tax on the first $1,000 of income one could "give" taxpayers a $2,000 tax credit. The net effect would still be the same as exempting the first $1,000 of income. Any tax credit may thus be made the equivalent of any exemption, provided that the relevant rate schedule may be varied.

19/ The benefit received from a tax credit is, of course, the same for all taxpayers, provided that these taxpayers have tax liabilities against which to offset the credit. For non-taxpayers, the benefit of either an exemption or a credit is irrelevant, since they have no taxes which can be reduced. To equalize these benefits would require the use of transfer payments that would be, in effect, "negative taxes". Such approach should be considered in the detailed examination of the

transfer payments of the federal government which we have recommended be undertaken.

20/ Comparisons which incorporate the effect of changes in the tax base that we recommended are presented in Chapter 36.

21/ As has already been noted in Chapter 4, the rate of economic growth is substantially affected by the growth of the labour force. Removing some of the tax disincentives for working wives and mothers would increase female participation in the labour force and so increase the rate of economic growth.

22/ Many of these expenses are nothing more than a purchase of increased leisure time and freedom from unpleasant household tasks. As we have previously noted in Chapter 8, in principle it would be desirable to tax imputed income obtained in the form of leisure. If this were administratively feasible, it would be appropriate to allow the deduction of household expenses associated with obtaining the imputed income. However, since it is obviously completely infeasible to tax imputed income, it would not be equitable to allow such expenses to be deducted.

23/ Where a wife worked for her husband or for a business in which he had a substantial interest, she should have the onus of establishing bona fide full-time employment for the required period. She should also be required to make a declaration to this effect if she claimed the credit. Alternatively, if this proved impossible to administer, it may be necessary to deny the credit where the wife worked for her husband or a corporation controlled by him.

24/ As noted in Chapter 7, a tax credit given to reflect any particular circumstance is equivalent to an assumption that the additional non-discretionary expenses resulting from that circumstance are equal to the tax credit divided by the rate of taxation of income available

for discretionary use. Because our rate schedules would levy a 50 per cent tax on what we believe to be discretionary income, the credits we recommend reflect an allowance for additional non-discretionary expenses that is twice the amount of the credit.

CHAPTER 12

CONCESSIONARY ALLOWANCES

In this chapter we discuss the treatment that should be accorded the specific non-discretionary expenses listed in Chapter 7 (with the exception of the expenses of working mothers dealt with in Chapter 11) and the concessionary allowances that should be introduced to assist in the realization of certain social goals.

As explained in Chapter 7, our ability-to-pay principles require that tax units with specific non-discretionary expenses be granted a credit against their tax liabilities equal to the top marginal rate (the rate of tax on discretionary income) times the expense. Such a credit is equivalent to a reduction of the assumed discretionary income of the tax unit by the amount of the specific non-discretionary expense. For administrative and other reasons we have not been able to adhere to this rule completely.

Concessionary allowances to encourage socially desirable activities must be judged primarily in terms of their effectiveness in bringing about the desired result with the minimum departure from ability-to-pay principles.

MEDICAL AND RELATED EXPENSES

Medical Expenses

The medical expense allowance was introduced in Canada with little debate in 1942. In view of the heavy taxes imposed at the time, it was felt necessary to grant relief for "unusual" medical expenses. The Honourable Mr. Ilsley, then Minister of Finance, said in his Budget Address that studies of family expenditures on medical services had shown that the average expenditure was 4 per cent to 5 per cent of income annually and, "we desire only to provide exemption for those who have more than average expenditures of this kind" 1/. Accordingly, a "floor" of 5 per cent was set and only medical expenses as defined in excess of the "floor" were allowed. The "floor" was

subsequently lowered to 4 per cent in 1944, and to 3 per cent, the present figure, in 1953. 2/

Under the present Income Tax Act every taxpayer may, if he wishes, take the optional standard deduction of $100 in lieu of medical expenses and charitable donations. This administrative allowance and the 3 per cent "floor" replace what otherwise would be a very large number of small deductions for these items. If the taxpayer does not take the standard deduction of $100 he may claim the actual medical expenses (in excess of the 3 per cent "floor") if they are itemized.

We believe that, in the absence of universal and comprehensive medical and hospital insurance, a refundable tax credit equal to a substantial proportion (preferably 50 per cent-the top marginal rate) of the medical expenses in excess of a percentage of income would be the most equitable method of giving tax relief to individuals and families with heavy medical expenses. The "floor" would eliminate claims for small amounts and thus make the system administratively feasible; the large and refundable credit for medical expenditures in excess of the floor would substantially reduce tax liabilities or provide refunds, when catastrophic medical expenses were incurred. With refundable medical expense credits the tax system would, in effect, provide a form of partial medical and hospital insurance. Whether such provisions in the tax system would serve the desired social objectives as well as the present hospital insurance or the proposed medicare programme, we have not attempted to evaluate. Clearly, to recommend a completely new if partial system of medical-hospital insurance almost as an aside would be, to say the least, presumptuous. We have assumed that the present system of hospital insurance will be continued and that in the near future some form of universal and comprehensive medicare will be provided by government, as has been announced. When comprehensive medicare, including drug and dental costs, becomes a reality, special tax provisions for medical expenses probably would be unnecessary. The recommendations we make should be reconsidered in the

light of the system of medicare actually adopted. We look upon our recommendations with respect to medical expenses as interim measures.

We have not attempted to make recommendations about the appropriate definition of medical expenses. We can see no hope of formulating a definition that does not lead to borderline cases whose very existence would constitute a plausible argument for expansion of the definition. In the past the government has expanded the definition to remove anomalous situations when they arose; there seems no alternative to this ad hoc procedure.

We considered whether there should be some greater control over receipts for medical expenses, and in particular druggists' receipts. We concluded that this was basically a matter that could be left to the administration. Our recommendations would substantially reduce the number of receipts being filed. We suggest, however, that consideration be given to requiring a uniform type of medical receipt for tax purposes that could be readily handled with electronic data processing equipment.

However, we do make recommendations about the tax treatment of medical insurance. The present treatment of medical insurance is, we believe, both inconsistent and inappropriate. By medical insurance we mean insurance that has as its purpose the payment of the sorts of expenses covered by the definition of medical expenses in the Act. For many years the general rule has been that premiums or contributions for medical or hospitalization coverage were not deductible, but that medical expenses paid on behalf of the taxpayer by an insurer or through a medical or hospitalization plan were deductible. Thus, the latter have been treated as though they had been paid by the taxpayer for the purpose of computing his medical expense deduction 3/. Section 27(1)(c) has, in effect, been interpreted to permit the deduction of medical expenses paid on behalf of a taxpayer as well as "by the taxpayer or his legal personal representatives". However, premiums and contributions paid for protection against the contingency of medical expenses are not deductible,

even under a broad interpretation of the section.

An exception to the general rule is stipulated in section 27(4a), enacted in 1959, which prohibits the taxpayer from including in his deductible medical expenses those paid by him or on his behalf for which he is entitled to be reimbursed under the following legislation:

1. Legislation of a province which has a hospital care insurance plan to which the federal government makes contributions.

2. Federal legislation authorizing a hospital care insurance plan for employees of Canada and their dependants.

Justification for this provision rests on the ground that medical expenses paid by the federal government directly, or indirectly by means of subsidies to the provincial hospitalization plans, should not be deductible as though paid by the taxpayer or his personal representative as section 27(1)(c) contemplates. If the law were otherwise, the taxpayer would enjoy a double benefit at government expense.

There are three situations involving what we have called medical insurance. The following summary contrasts these situations and their tax consequences.

Situation	Tax Treatment of Premium	Tax Treatment of Benefit
1. Employer pays premium under group sickness, accident or medical services plan.	Premium not included in employee's income.	Medical expenses paid on insured's behalf not included in his income, but included in computing the medical deduction.
2. Taxpayer pays own medical insurance premium.	Premium not deductible.	Medical expenses paid on insured's behalf not included in his income, but included in computing the medical deduction.
3. Employer or taxpayer pays government hospital insurance premiums or taxes in lieu of premiums.	Employer-paid premium included in employee's income. Taxpayer paid premium not deductible.	Medical expenses paid on insured's behalf not included in his income or in computing the medical deduction.

The legislative sanction for the exclusion of the premium in situation 1 is section 5(1)(a), which excludes from taxable employee benefits the benefit the employee derives from his employer's contribution to a group sickness or accident insurance plan or medical services plan. The rationale for such exclusion presumably is to encourage group insurance plans to protect employees against illness, and to overcome the administrative difficulty of apportioning a group premium of this nature among individuals in the group because of age and insurability differences.

However, there is a fundamental inequity when we compare situation 1 with situation 2. In situation 1, not only is the employer-paid premium not included in the employee's income but the benefits paid on behalf of the employee are considered as though paid by him so that they come within the definition of medical expenses for deduction purposes. In situation 2, where the taxpayer provides his own insurance, he of course gets no deduction for his premium although the benefits paid out of the insurance are includible in computing the medical expense deduction.

Situation 3 is inconsistent with situation 1 with respect to employer-paid premiums, and inconsistent with situations 1 and 2 with respect to benefits. The reason advanced for the inconsistent treatment of benefits has already been given. The inconsistent treatment of premiums arises in part because of the different methods of financing hospital insurance in different provinces. Ontario, Manitoba and Saskatchewan charge a premium; the other provinces finance these hospital insurance plans from sales taxes or other tax revenues. Unless residents of the latter provinces were allowed to deduct a proportion of their sales taxes or other taxes paid, it would be unfair to allow taxpayers in the three provinces to deduct their premiums or to allow employers to pay premiums for employees without adding such premiums to the income of their employees.

The present treatment of medical insurance is not only inconsistent; it gives rise to the unreasonable result that a taxpayer covered by medical

insurance who has a large medical expense can actually be better off in the year of the illness; the insurance meets the expense but the expense, in excess of 3 per cent of income, is deductible to the taxpayer. We have come to the conclusion that consistency and reasonableness can both be improved by reversing the present approach. Ignoring the floor for the moment, taxpayers should only be allowed to deduct actual out-of-pocket expenses including medical insurance premiums or medical service plan contributions. The medical expenses paid under such plans should not be deductible. Thus, if a taxpayer paid a medical insurance premium of $150 and also paid medical expenses of $2,000, for which he was reimbursed under a medical insurance policy or plan to the extent of $1,000, the eligible expenses would be $1,150 not $2,000.

As more and more taxpayers are covered by some form of medical insurance policy or plan, and as the benefits under these policies or plans become more comprehensive, fewer and fewer taxpayers will have out-of-pocket medical expenses over and above their premiums or contributions. These premiums and contributions will be about the same for all individuals and for families of the same size.

To allow the deduction of all premiums and contributions would then be tantamount to allowing a standard deduction to all taxpayers. This would not only reduce the tax base, thereby requiring higher rates, it would also provide a more valuable concession to those with high marginal rates than to those with low rates, and such a result would not meet the objectives of the concession. We therefore recommend that the 3 per cent floor 4/ on the deduction of medical expenses should be retained and that the present standard deduction for medical expenses should be eliminated. Because the present standard deduction covers more than medical expenses, the current amount should be reduced. Because the 3 per cent floor is related to income, low income individuals and families would obtain some deduction from income with respect to medical premiums and contributions while middle and upper

income individuals would not. To be deductible, out-of-pocket costs other than premiums and contributions would have to be relatively greater for upper income taxpayers than for low income taxpayers.

We recommend, however, that the present treatment of government hospital insurance premiums should be retained. These premiums should be added to the incomes of employees when paid by an employer and should not be deducted when paid by an individual or family. This would be necessary to achieve consistency among taxpayers in all provinces.

Our recommendations would substantially reduce the number of taxpayers presently claiming medical expense deductions in excess of the 3 per cent floor without creating hardships. Catastrophic medical expenses not covered by insurance would continue to be deducted as at present. We think it will be recognized by most taxpayers that lower personal tax rates are preferable to standard deductions and to claims for medical expenses that were not actually paid by the taxpayer.

Blind or Confined to
Bed or Wheelchair

Section 27(1)(d) of the <u>Income Tax Act</u> provides for a special deduction from income of $500 which may be claimed by a <u>taxpayer</u> who:

1. Was <u>at any time</u> in the taxation year totally blind; or throughout <u>the whole</u> of the taxation year was necessarily confined to a bed or wheelchair, by reason of illness, injury, or affliction; and

2. Made no claim for medical expenses on account of remuneration for an attendant or care in a nursing home, by reason of his blindness, illness, or affliction.

Two points are apparent. First, the section only refers to a taxpayer so that the deduction is not available with respect to a dependant. Second, if the taxpayer is blind, he need only be blind for one day in the year to

qualify for the full deduction for the year. However, if the taxpayer is injured on the second day in the year and confined to bed for the rest of the year he does not qualify, because he was not "throughout the whole of the year, necessarily confined...." The logic escapes us.

Further, if the person confined to a bed or a wheelchair claims a deduction for actual medical expenses under section 27(1)(c)(iv) for remuneration for a full-time attendant, the special deduction of $500 is not available. Similarly, a blind person cannot claim both the special $500 deduction and expenses covered by section 27(1)(c)(v).

Because a deduction of actual expenses without ceiling is permissible, it is difficult to understand the need for the alternative treatment provided under section 27(1)(d), which is used only when the actual deductible expenses are less than $500.

Accordingly, it is our recommendation that section 27(1)(d) should be repealed.

The Aged

Special deductions from income are granted the aged in the Income Tax Act. Under section 26(1)(e), a deduction of $500 is granted to any taxpayer who has attained the age of 70 years. Under section 26(1)(f), a deduction of $500 is granted to any taxpayer who is between the ages of 65 and 70 years if a pension under the Old Age Security Act has not been authorized to be paid to him. This latter provision applies only to the 1966 to 1969 taxation years and was introduced to harmonize provisions of the Income Tax Act with respect to the aged, and the provisions of the Old Age Security Act.

These income tax provisions are not well suited to the provision of relief for aged persons with low incomes.

1. The most obvious problem is that the use of an exemption is of no benefit at all to those aged persons who are truly in need because they have little or no income.

2. It is sometimes argued that the very fact that a taxpayer has achieved the age of 65 (or 70) years means that his ability to pay has been reduced and therefore an additional exemption is justified. The information we have been able to gather does not support the contention that the economic circumstances of the aged justify a blanket exemption from income. One study indicates that a significant proportion of elderly persons and couples are wealthy, and a disproportionately high percentage of the wealthy are old people 5/. Another study showed that a couple over age 65 would ordinarily incur approximately 6 per cent less cost in maintaining a given standard of living than a couple between 35 and 65 years of age 6/. These studies relate to the United States but the same comparisons are probably generally true in Canada. We appreciate that retired people often have to live on less income than they had before retirement, but this fact is properly recognized by graduated personal tax rates.

3. There is reason to believe that the elderly are more prone than the average individual to unusual medical expenses, but we believe that our recommendations concerning medical expenses would be adequate to meet the needs of the elderly who had taxable income.

The basic problem, of course, is that an exemption is a very inadequate basis for a good welfare scheme. The way to help the most underprivileged is by positive assistance, not by income tax concessions that fail to discriminate between the needy and the affluent, that give no benefit where it is needed, but do give a benefit where it is not needed. We hope that a thorough review of Canadian welfare legislation will be undertaken. Until such a study is instituted, we recommend that section 26(1)(f) of the Income Tax Act should be retained, but that section 26(1)(e) should be repealed.

CHARITABLE DONATIONS

If equity were the only consideration, we would propose a system of tax credits for charitable donations. For example, under such a system a taxpayer who made charitable donations of $1,000 or more might receive a tax credit of $200. Taxpayers who donated less than $1,000 might receive a credit that was the same proportion of $200 that the actual donation bore to $1,000. The tax concession would thus be related only to the size of the donation and would not also depend upon the income of the taxpayer. The credit approach would, however, tend to stifle charitable giving by upper income individuals and families. Because we believe that private philanthropy performs a worthwhile social purpose 7/ we recommend that the fundamental feature of the present system, the deduction of charitable donations from income, should be continued.

Our recommendations as to the tax treatment of charitable organizations are set out in Chapter 20. We suggest there that their present tax-exempt status should continue, with exceptions for certain business and investment income.

The major practical problem relating to charitable donations is to ensure that the receipts issued by a charitable body are matched by actual contributions to it. A greater measure of control could be achieved if the following requirements were introduced:

1. Receipts should be in triplicate using forms supplied by the tax authorities, one copy to be given to the donor, one to the tax authorities, and one to be retained by the charity itself.

2. The charitable bodies should be required to maintain complete records of individual and total contributions received during the year, and to make such records available for inspection by the tax authorities.

3. The charitable bodies should be required to file annual returns of their gross receipts 8/.

It has been suggested that electronic data processing could be utilized to monitor charitable deductions. We agree that this could be done, but we are not certain that at the present time the expense of setting up a programme for this purpose would be justified.

The law to date, with two exceptions, requires that for charitable donations to be deductible the recipient charitable organization, trust, corporation, etc., must be in Canada 9/. By way of exception, a person resident in Canada whose chief source of income for the year is from an employment or business to which he commuted in the United States, may deduct his contributions to United States charitable organizations recognized as such under the United States Internal Revenue Code in the same manner as if he had contributed to a Canadian recognized charitable organization. Similarly, a Canadian taxpayer may claim a deduction not exceeding 10 per cent of his income from United States sources and taxable in Canada, for contributions to charitable organizations created under the laws of the United States as if the organizations were Canadian charitable organizations 10/. Thus, in these two exceptions the emphasis is on permitting charitable donations to organizations created in the United States out of income earned in the United States, presumably on the theory that some responsibility for good works lies in the jurisdiction whence the income flows.

We make recommendations in Chapter 20 that charitable bodies operating outside of Canada should be recognized and that deductions of contributions to a recognized charitable body should be permitted, whether or not the body operates in Canada.

At the present time the maximum charitable deduction is 10 per cent of the income of the taxpayer for the year with a one-year carry-over for amounts in excess of 10 per cent. We admire those who habitually make charitable donations in excess of 10 per cent of their income, and eloquent representations were made before us on their behalf. Nevertheless, we believe no change should be made until the administrative procedures recommended in

Chapter 20 with respect to charities have been implemented and have been found to be working satisfactorily. We recommend that at that time the limit on donations for individuals should be raised to 15 per cent of income. However, we recommend that no change should be made in the present 10 per cent limit for corporations 11/.

We have already recommended that the optional standard deduction should not be applicable to medical expenses. However, we believe that a good case can be made for an administrative concession in respect of charitable donations because there are so many small donations each with its own receipt. A limitation similar to that applicable to medical expenses, that is, restricting the deductibility of charitable donations to the amount exceeding 1 per cent of income, would appear to be preferable; but a limit of this nature might tend to restrain charitable giving by upper income taxpayers that the allowance is designed to encourage. A somewhat parallel problem could arise if an optional standard deduction, that is, a minimum amount that could be claimed instead of listing the actual donations and irrespective of the amount of actual donations, were too large, because it would then have a perverse incentive effect, discouraging those people from making moderate donations who could claim the standard deduction in any case. For these reasons, we recommend that an optional standard deduction should be retained for charitable donations, but that it should be limited in size to the minimum amount necessary to achieve the desired administrative savings. An amount of not more than $50 would appear to be appropriate for this purpose.

Section 27(1)(a) of the Income Tax Act provides that donations to Canadian provinces and municipalities may be included with charitable donations which are deductible for tax purposes, subject to the limit equal to 10 per cent of the taxpayer's income. Section 27(1)(b) provides that all gifts made to the Canadian government are deductible without limitation. We recommend that these provisions should be continued.

Gifts in Kind

Under the Income Tax Act charitable gifts in kind may be deducted provided they are supported by receipts from the donee charitable organization 12/. The one case that bears directly on the subject was decided on the ground that the transfer was not effected in the form of a gift 13/. In this instance a taxpayer sold a house to a church for use as a rectory for one half its value and claimed the other half as a charitable deduction. He lost his case. One wonders what the result would have been had he sold a one-half undivided interest in the house to the church and then followed this with a gift of the other half.

We see no reason why substantial gifts in kind should not be recognized. We have in mind the sort of thing the taxpayer was denied in the Gaudin case, as well as gifts of objets d'art to museums and similar institutions. Two points must be made clear. First, if a gift in kind were made, an unconditional and irrevocable transfer of ownership and possession to the donee must be effected before a donation is recognized for tax purposes. We do not believe that a deduction should be allowed of the value of a gift in kind which is made on condition that the subject of the gift, for example, a painting or a china collection, is to remain in the donor's possession for his enjoyment until some subsequent time.

On the other hand, we do not believe that small donations in kind of such things as old clothes and old furniture to charitable bazaars should be deductible, because of the administrative problems this would create. To minimize these administrative problems we would suggest that donations in kind should be deductible only to the extent that they exceed $500 in value in any year.

Second, there is a problem of valuation. Within the concept of the comprehensive tax base recommended in this Report, the transfer of an asset out of a tax unit would involve a deemed realization of the increase in the

value of the asset over the period of time for which the asset had been held. For example, if an individual purchased for $500 a painting which appreciated in value to $2,000, at which time he disposed of it through sale, the realized increase in value of $1,500 would be subject to tax in his hands. Suppose now that instead of selling the painting he donated it to a museum. In this case, he would add the gain of $1,500 to his income, but he could claim $1,500 ($2,000 less the $500 annual exclusion for gifts in kind) as a charitable donation if the amount did not exceed the limitation on charitable donations 14/.

Members of Religious
Orders and Postulants

Section 27(2) provides that where a member of a religious order has taken a vow of perpetual poverty and has in fact paid his earned income for the year to the order, he shall not be taxed on such income. We recommend that this provision should be repealed.

A different but related question arises with candidates for membership in religious orders, that is, postulants. They normally engage themselves in a trial period which may extend over several years, during which time they and the particular religious order seek the answer to the question "Is the postulant a suitable candidate for membership?" We recommend that one postulant under the age of 19 should be allowed as a dependant of each member of the religious order to which he seeks entrance, provided that the postulant has not been claimed as a dependant by parents or others.

Political Donations

Political donations at the present time are not deductible. However, there might be some merit in providing a 25 per cent tax credit for political donations of up to $50 per individual tax unit and $100 per family tax unit a year. It has been urged that such an approach would help ensure that political organizations, so vital to the maintenance of the parliamentary

system, have a broad base of financial support. This question is one which is not within our area of responsibilities, for the issues go far beyond taxation. However, we feel that it deserves public discussion, and implementation if it is as desirable as we are inclined to believe.

ANNUAL AND LIFETIME GIFT EXEMPTIONS

Under the comprehensive tax base, gifts would be brought into the income of the donee and would not be deductible in computing the income of the donor. However, under the family unit concept, gifts between members of a family unit, as we have defined it, would have no tax consequences. This would mean that a large proportion of all gifts would fall outside the purview of the tax system. Nevertheless, there are many small gifts of a "routine" nature between individuals and families that would be taxable under the proposed system unless some relieving provisions were available. Wedding gifts, birthday gifts and gifts made on religious holidays are obvious examples. It would be unreasonable to expect that donors would report to whom these small gifts were made and their value. Evasion would be rampant, because it would be unrealistic to expect that all donees would include them in income, and the administrative problems of valuation could be formidable. As a practical matter, we recommend in Chapter 17 certain annual and lifetime exemptions for gifts received that would mean that most people would not be taxed on the small gifts they received throughout their lives.

GIFTS IN SUPPORT OF DEPENDANTS

The present Act allows taxpayers certain deductions from income when they support close relatives who are dependent, usually wholly dependent upon them. The donor can support the dependant through gifts of as much as $1,000 a year without affecting the gift tax or the gift

tax exemptions of the donor. Adoption of our proposals would bring about a radical change. Gifts in support of wives, or husbands, or dependent children as we have defined them, would not be subject to tax to the donor or donee because wives, husbands and dependent children would all be members of the family unit and such transfers would not be subject to tax. However, without relieving provisions, gifts to parents of either spouse, aunts, uncles and children over 21 years of age who were not in full-time attendance at an institution of higher education or were not mentally or physically infirm, in excess of the annual and lifetime gift exemptions would be taxable to the donee and not deductible to the donor.

We considered but rejected the idea of allowing impecunious close relatives to become members of the family unit for tax purposes. To do so would unduly complicate the family unit concept because it would require elaborate provisions to prevent tax-free transfers between generations. However, there can be no doubt that individuals and families are often morally required to support, in whole or in part, aged or infirm relatives. These expenditures are non-discretionary and deserving of recognition. Without some form of concession the family tax unit would be too rigid; for aged and infirm parents and other close relatives are often thought of as members of the family. To accommodate the obligations of individuals and families to support close relatives, we recommend that a system of tax credits should be adopted as a concession to individuals and families making gifts to close relatives. The donor tax unit should be granted a tax credit of $100 for each close relative to whom $1,000 or more had been given in the taxation year. Smaller gifts to close relatives would entitle the donor to the appropriate proportion of the credit. Thus, a gift of $500 would entitle the donor to a credit of $50, a gift of $250 would entitle the donor to a credit of $25, and so on. We recommend that complete dependency snould not be a necessary condition for the tax credit. The donor should only have

to establish that the gift was actually made and that the donee was a close relative who was outside the donor's tax unit. This should facilitate administration of the tax credit. The close relative should not have to be a Canadian resident. A resident recipient of such a gift would have to bring it into income (to the extent that it exceeds his annual and lifetime exemptions), but if he had little other income and the gift was modest, the zero rate bracket applicable to all individuals and families should mean that there would be little or no tax on the gift.

A common method of assisting aged and infirm parents and other close relatives is for the taxpayer to provide them with free room and board in his home. The gift is in kind rather than cash. To avoid the valuation problem that would arise in these circumstances, we suggest that when a close relative is sharing the same domicile as an individual or family tax unit the tax unit should be deemed to have provided the close relative with a gift of $1,000 less any amount contributed by the relative toward expenses for clothing and shelter. If the relative had made no such contribution the donor tax unit would be entitled to the $100 credit. The relative would be required to take into income the $1,000 benefit in kind less any amounts falling within his annual or lifetime gift exemption. If this were the only income of the relative the zero rate bracket applicable to each individual tax unit would mean that there would be little or no tax on the gift.

POST-SECONDARY EDUCATION

We are concerned here with a student enrolled in an educational institution "that is a university, college or other educational institution providing courses at a post-secondary school level" 15/. Under the present law a student enrolled at a post-secondary educational institution in Canada may, in computing his income, deduct his fees as long as they exceed $25.

If the student is in full-time attendance at a university outside Canada in a course leading to a degree, he may deduct his fees in computing his income so long as the course is of not less than thirteen consecutive weeks' duration 16/. If the student relies on someone else for support, full-time attendance at university has a number of consequences, depending upon family status, degree of relationship and degree of support 17/.

We are fully in accord with the generally held belief that Canada should encourage a higher proportion of its citizens to improve their education. Despite the massive increases in government expenditures on post-secondary education in recent years, the proportion of Canadians proceeding to university still lags far behind the proportion in the United States. Because of the favourable effects of higher education on the growth of the economy and on the quality of our society, this gap should be closed. This could be achieved in a number of ways. Universities could be given increased grants so that fees could be reduced, and more students could be provided with more generous bursaries to meet their living costs. Loans and grants to students could be provided that would make it possible for more students to buy the higher education they want. Tax concessions could be provided that would make it easier for parents to finance the education of their children, or students to finance their own education.

We have not attempted to evaluate which technique or combination of techniques would be preferable. To have done so would have taken us far beyond our terms of reference. Our predilection is for increased government expenditure; but we thought it would be unwise for us to assume that government grants would increase so rapidly that other assistance would not be necessary. We therefore have made recommendations that we believe would encourage post-secondary education more equitably and effectively than the present tax provisions. By putting forth these recommendations we do not wish to imply that the tax concessions technique is the best technique, or that the proportions or dollar limits we suggest are in any sense firm recommendations. We are primarily interested in the method rather than the

amounts. The amounts should be determined in the light of the objectives and the expenditure decisions that are taken.

In Chapter 10 we recommend that a child, over the age of 21 but under 25, and in full-time attendance at an institution of post-secondary education, should be permitted to elect jointly with his parents, or parent where there is only one, to continue to be a member of the family unit. This would not only avoid the taxation of gifts from the parents to the child for the purposes of education in these circumstances, but would also facilitate the implementation of our recommendations with respect to tax credits.

In reaching our recommendations, we have tried to achieve a system with the features listed below:

1. We believe that the living costs of students should be recognized when they are not able to rely on their parents for support.

2. For reasons of equity we have repeatedly emphasized that relief for those incurring the costs of post-secondary education should be by way of tax credit rather than by deduction.

3. The tax relief should be available to the tax unit of which the student is a member.

4. Unused tax credits for post-secondary education should be carried forward to facilitate the repayment of loans when the graduate has income.

Our proposals as to post-secondary education allowances are:

1. A tax credit equal to one quarter of the fees paid by or on behalf of the student for post-secondary education should be provided. It would apply to the tax unit in which the person paying the fees was a member. It would be more valuable than a deduction for lower income tax units, and would be of relatively less importance to higher income tax units.

2. A further annual credit of up to $300 in recognition of living costs should be provided for a full-time student in an institution providing post-secondary education when the student is not a dependent child, as defined in Chapter 10. The credit for living costs would apply to the tax unit of the student.

3. Unclaimed credits should be carried forward and could be used to reduce tax liabilities at any time.

The concessions we suggest for full-time post-secondary education would provide a much greater incentive for the vast majority of taxpayers than the present system of deductions. The credit would provide the greatest relative assistance for low income parents and students with low incomes in their initial post-graduate years. We would expect that if the approach we recommend were implemented, the amounts we have suggested should be reviewed from time to time in the light of other policy decisions in the realm of higher education.

Further Training

Increasingly in the modern world,training and education continue throughout a person's working life and do not terminate with the attainment of a certificate or degree. Retraining and up-grading courses of various kinds are becoming an essential feature of many employments and professions. We assume that all of the costs of such courses, both fees and travelling and living expenses in excess of normal living expenses, would be reasonably related to the production of income and should therefore be deductible from income under the general rules for deductibility we recommend. Nevertheless, for greater certainty it might be useful to specify this in the Act. However, because we also recommend that full-time post-secondary education costs should be provided for by special tax credits, the costs of full-time post-secondary education would have to be specifically excluded as a deduction from income.

To permit the deduction of the costs of part-time or short-term training courses should remove a significant tax barrier to the maintenance of the skills and knowledge of both the employed and the self-employed. No concession would be required; only a less restrictive approach to the deductibility of the expenses of producing income. This more liberal approach can be justified on grounds of equity and neutrality.

CONCLUSIONS AND RECOMMENDATIONS

1. Some personal expenditures are made by individuals and families that are non-discretionary in whole or in part. There are other personal expenditures that serve a useful social purpose and, as a matter of public policy, should be encouraged. In equity, tax concessions should be granted to reflect the reduced ability to pay of those who have non-discretionary expenses and to provide an effective incentive to achieve a better realization of social goals.

2. Tax concessions designed to take into account non-discretionary expenses should, ideally, be of greater relative value to low income taxpayers. This principle follows because we believe that a given non-discretionary expenditure reduces ability to pay taxes relatively more when it is a large proportion of income than when it is a small proportion of income.

MEDICAL AND RELATED EXPENSES

3. The out-of-pocket medical expenses of taxpayers are non-discretionary expenses. While maximum equity might be achieved by providing for a refundable tax credit equal to a substantial proportion of the medical expenses in excess of modest limits, this would convert the income tax system into a medical insurance system; and such an approach may not be the most socially acceptable form of medical

insurance. We therefore recommend that the deduction approach should be continued.

4. The present approach, which prohibits the deduction of medical insurance premiums and contributions but allows the deduction of amounts paid under such policies and plans, leads to anomalous results.

5. Deductible medical expenses should include only amounts actually paid by individual and family tax units. The premiums or cost to a tax unit of medical insurance, the taxpayer's contributions to a medical services plan, and other out-of-pocket medical costs paid by the tax unit, should be treated as medical expenses. The benefits paid to or on behalf of a tax unit on account of medical expenses by insurers, medical services plans, etc., should not be treated as medical expenses of the tax unit because they are not paid by the members of the unit.

6. Premiums or other costs of governmental hospital service, as opposed to private hospital insurance or services, should not be treated as medical expenses of the tax unit because the provinces use different methods of financing hospitalization and no equitable pattern for federal income tax deductibility appears to be possible.

7. An optional standard deduction should not be available for medical expenses; the present standard deduction should therefore be reduced and used only for charitable donations.

8. In other respects the present rules with regard to medical expenses should be maintained. Thus, we have no specific recommendations for changes in the definition of medical expenses. In addition, the present restriction that only permits the deduction of expenses in excess of 3 per cent of income should be retained.

9. Our recommendations would substantially reduce the number of middle and upper income taxpayers claiming medical expenses.

10. The special deduction of $500 for taxpayers who are blind or confined to a bed or wheelchair and who do not claim certain defined medical expenses should be withdrawn. All the medical expenses of these illnesses in excess of 3 per cent of income would, of course, be deductible in the manner outlined above.

11. The special deduction from income of $500 for a taxpayer who has reached the age of 70, should be terminated.

CHARITABLE DONATIONS

12. To encourage charitable giving, a socially desirable objective, we recommend a continuation of the same basic system now in effect. However, some additional safeguards would be required.

13. Charities should file annual returns of their gross receipts.

14. The issuance of numbered charitable receipt forms should be controlled by the tax authorities.

15. The limit on charitable gifts should be increased to 15 per cent of income for individuals as soon as the administrative procedures we recommend have been implemented. The limit should be retained at 10 per cent for corporations.

16. Gifts to provinces and municipalities should be deductible in the same way as charitable donations and should be aggregated with charitable donations in determining the amount deductible. Gifts to the Canadian government should be deductible without limitation. In these respects the present law would remain unchanged.

17. The optional standard deduction should be set at an amount not exceeding $50 and should be restricted to charitable donations.

This deduction is recommended solely to reduce the administrative problem involved in processing a multitude of receipts for small amounts.

18. Outright gifts in kind to charitable organizations in excess of $500 in any year should qualify as charitable donations. On the making of such a gift the taxpayer would be deemed to have sold the property at the fair market value.

19. The special deduction from income of an amount equal to his earned income for the year, now available to a member of a religious order who has taken a vow of perpetual poverty, should be discontinued.

20. A member of a religious order should be able to claim as a dependant a postulant of that order under the age of 19, if the postulant is not being claimed as a dependant by another taxpayer.

POLITICAL DONATIONS

21. Consideration should be given to allowing a 25 per cent tax credit for political donations up to $50 per individual tax unit and $100 per family unit a year.

POST-SECONDARY EDUCATION

22. The present concession with respect to the expense of post-secondary school education, section 11(1)(qc)(i) of the Act, should be withdrawn and replaced by a tax credit system. This would provide a more effective and equitable concession. There should be a tax credit of one quarter of the fees paid by or on behalf of the student to the post-secondary educational institution. A further credit of up to $300 per annum should be allowed for the living costs of a student who is not a dependent child. The credit for fees should be available to the family unit of which the person paying the fee is a member; the credit for the living costs should only be available

to the student's tax unit. The credits should be cumulative, and to the extent not claimed should be carried forward indefinitely and be deductible at any time in the future.

23. The cost of part-time or short-term courses including fees and travelling and living expenses in excess of normal living expenses would be deductible under the general rules for deductibility we have recommended and tax credits should not be allowed in respect of such courses.

ANNUAL AND LIFETIME GIFT EXEMPTIONS

24. For administrative reasons, we recommend in Chapter 17 certain annual and lifetime gift exemptions.

GIFTS TO CLOSE RELATIVES

25. A tax credit of $100 should be provided to a tax unit making gifts of $1,000 or more in a year to a close relative outside the tax unit. The credit should be proportionately reduced for smaller gifts. When a close relative is provided with room and board in the home of the taxpayer throughout the year it would be deemed that the taxpayer had made a gift of $1,000 less any amount contributed by the relative toward the cost of room and board. The recipients of these gifts would be required to bring them into income. Because of the zero rate brackets and the annual and lifetime gift exemptions available to all tax units, the tax on modest gifts to close relatives with low incomes would be reduced or eliminated.

REFERENCES

1/ House of Commons Debates, June 23, 1942, p. 3580.

2/ The United States also initiated their medical expense deductions in 1942 and set the floor at 3 per cent, where it still is. The United Kingdom has no medical expense deduction. As originally enacted, the Canadian medical expense deduction was also subject to a "ceiling" which was removed in 1961. So far as we are aware, little difficulty has been experienced by the administration as the result of lifting the ceiling in 1961. In any event, it seems reasonable that very large medical expenses will be scrutinized by the Department and it does not seem that the Treasury will suffer if the burden of proof is on the taxpayer.

3/ This interpretation had its genesis when medical insurance was the exception rather than the rule and before the spread of government hospital and medical plans.

4/ The floor would be 3 per cent of income as determined before the deduction of medical expenses and charitable donations but after the deduction of all losses carried forward. Losses incurred in subsequent years would not be taken into account because of the complications this would cause in recalculating the medical expense allowance and in averaging income. The legislative technique to be followed would be a matter for the draftsman, but it would probably not be necessary to retain the present distinction between "income" and "taxable income".

5/ See Robert J. Lampman, The Share of Top Wealth-Holders in National Wealth, 1922-56, National Bureau of Economic Research, Princeton, N.J.: Princeton University Press, 1962, pp. 17-21.

6/ United States Department of Labour, Monthly Labor Review, November 1960, p. 1198. The study deals with "modest but adequate" budgets and covers the 20 largest United States cities.

7/ Our reasons are substantially the same as those in Gwyneth McGregor, "Charitable Contributions", Canadian Tax Journal, Vol. IX, 1961, p. 441.

8/ 1966 Budget Resolution No. 2 has proposed that, for the 1967 and subsequent taxation years, charitable gifts will be deductible only if the donee is a registered charitable organization which has been registered with the Minister and has filed a return in prescribed form. This Resolution has now been implemented by amendment of section 27.

9/ 1966 Budget Resolution No. 2 has proposed that, for the 1967 and subsequent taxation years, deductible charitable donations may include gifts to the United Nations or any agency thereof, to a prescribed university outside Canada which ordinarily has students from Canada, or to a charitable organization outside Canada to which the Canadian government has made a gift in the year. This Resolution has now been implemented by amendment of section 27.

10/ The authority for these two exceptions is found in section 27(3) of the Act and Article XIII D of the Canada-United States Reciprocal Tax Convention.

11/ The limit would be a percentage of income as determined before the deduction of medical expenses and charitable donations but after the deduction of all losses carried forward. It would seem unfair to take into account losses carried back because if they were deducted it would have the effect of disallowing donations which were properly deductible when made. See reference 4 above.

12/ Section 27(1) of the Act refers to the deduction of "such of the following amounts as are applicable: (a) the aggregate of gifts...." Section 139(1)(a) states that "(c) amount, means money, rights or things expressed in terms of the amount of money or the value in terms of money of the right or thing." It therefore appears that a gift of a thing is a gift of an "amount" within the meaning of the charitable deduction section.

Information Bulletin 17 published by the Taxation Division in Part I of the Canada Gazette, December 22, 1962, does not challenge the generality of this statement. It does state that donations of inventory that has been expensed and of second-hand goods will not be recognized.

13/ Gaudin v. M.N.R., 55 DTC 385.

14/ In the opposite case where a painting or other objet d'art was purchased by an individual for $2,000 but had a fair market value of $1,200 when donated to the museum, he would be permitted to claim a charitable donation of $700 ($1,200 less the sum of $500 which is the annual exclusion for gifts in kind). He would also be permitted to claim the $800 loss from realized property gains derived from the same type of property. See Chapter 15.

15/ Section 11(1)(qc)(i), Income Tax Act.

16/ Section 11(1)(qb).

17/ Section 26(1)(c), (ca) and (d).

CHAPTER 13

INCOME AVERAGING

We believe that taxes are fair when they are allocated according to ability to pay, and that this would be achieved by the application of a progressive rate structure to the annual tax base we have defined. One of the consequences of the adoption of a progressive rate schedule is that two individuals with the same average tax base may, over a period of years, pay substantially different taxes if the annual tax base of one fluctuates more than that of the other. The greater the fluctuation the greater the tax liability. This phenomenon poses several problems:

1. There is nothing sacrosanct about the measurement of income for tax purposes on an annual basis. The choice of the calendar year as the relevant time period is a matter of convention and convenience rather than principle. We can see no justification in equity for imposing substantially heavier taxes on those with fluctuating incomes, because there is no fundamental objection to the adoption of a longer time period and a longer time period would not produce this result. Some smoothing of income over a period of years would seem to us to be called for. We are not convinced, however, that equity demands income smoothing over a taxpayer's lifetime.

2. Without relief for irregular incomes the tax authorities would be drawn into an endless struggle to try to prevent taxpayers from manipulating the timing of their receipts or gains so as to minimize their tax liabilities. This struggle would produce ever greater complexities or arbitrariness in tax laws.

3. If there were no relieving provisions, those people who were able to manipulate the timing of their receipts or gains would, despite the efforts of the tax authorities, have an advantage relative to those who could not do so.

4. Unless there was some form of relief to those with irregular or fluctuating incomes, individuals might avoid occupations or businesses that were particularly subject to such variations.

These four points all seem to us to provide strong grounds for general relief from the tax consequences of lump sum or fluctuating incomes. In particular, the problem of taxpayer inequity is sufficient reason for providing relief even if it were possible to prevent the manipulation of income by taxpayers to avoid the full impact of progressive rates in each time period.

There is also a strong argument for the provision of some form of averaging because of the other recommendations made in this Report. Unless averaging provisions were available, the taxation of property gains at full progressive rates on a realized basis would, for example, be grossly unfair. It would be inequitable to tax realized gains as though they had arisen in the year realized. There are also other lump sum receipts that we recommend should be brought into tax, with the stipulation that the full impact of the progressive rates be softened by provisions that permit spreading of the receipts over a number of years. In particular, we believe that substantial gifts and inheritances, damage payments, and property gains realized or deemed to have been realized on death or cessation of Canadian residence all require relieving provisions.

Having acknowledged that relief should be granted on equity and other grounds, we hasten to add that this is not easily accomplished. All measures of relief for fluctuating and irregular income are relatively complex and create compliance and administrative problems. Many forms of relief have to be rejected simply because they would not be understood by many taxpayers or would require too much record keeping. As in so many other areas of the tax structure, what is required is a compromise between the desirable and the practical.

In Volume 2 of the Report we discuss at some length the importance of the built-in flexibility of the tax system. As the level of economic activity rises and falls, the rate structure automatically restrains expansions and contractions by increasing or reducing tax payments more than proportionately. This tends to stabilize the economy, although if the tax structure is too "tight" it can stabilize the economy at levels where labour, and other productive facilities and resources are not fully utilized. If substantial relief for fluctuating income were provided, the built-in flexibility of the system might be reduced. Whether it would be reduced, by how much it would be reduced, and under what conditions it would be reduced would depend, of course, on the particular form of relief provided and on changes in the other features of the tax structure. While built-in flexibility is not an unqualified advantage of a tax system, it should be recognized that some relief measures may make it more difficult to attain one of our economic objectives.

Little information is available in Canada with respect to the year-to-year fluctuations in the incomes of individual taxpayers. On the basis of two small and admittedly incomplete studies made by our research staff, we were surprised to find how general and substantial these changes apparently are. About 8 per cent of the sampled taxpayers in a number of Canadian metropolitan areas, with income below $10,000, reported year-to-year fluctuations of family income of more than 20 per cent from 1962 to 1963. 1/ In a survey of 450 taxpayers in two major Canadian cities, having income in 1962 in excess of $25,000, it was found that within the three-year period 1960-62, 20 per cent experienced fluctuations of more than 30 per cent in income for tax purposes from the highest to the lowest income year. This latter survey of upper income group individuals also showed that for these high income taxpayers, the higher the income the less on average were the percentage fluctuations in income in the period.

The tax impact of fluctuating income depends not only on the size of the fluctuations but on the rate structure. The width of the brackets, and the changes in rates from bracket to bracket, are obviously relevant. Analyses prepared by our research staff showed that the tax impact of a given degree of fluctuation under the existing rate structure is relatively modest at both the upper and lower ends of the income scale because the income brackets are relatively wide or the increases in tax rates from bracket to bracket are relatively small. It is the upper middle income group that has suffered most from fluctuating or irregular incomes.

The changes we recommend elsewhere in this Report would have two effects on the fluctuating income problem. Because of the widening of the tax base to include many non-recurring receipts that now are not taxed, the number of individuals who would experience year-to-year fluctuation in their tax bases would undoubtedly increase, and so would the extent of those fluctuations. On the other hand, the changes in the rate structure that we recommend would tend to reduce the tax consequences of these fluctuations, if only because we are suggesting a reduction in the top personal rates of tax.

PRESENT LEGISLATION IN CANADA

The problem of the equitable treatment of lump sum and fluctuating income as it exists under the present system has been recognized in part in the legislation. There are a number of provisions in the Income Tax Act designed to alleviate this problem in certain special cases, and in respect of certain types of income. Following is a brief summary of the main provisions.

Farmers and Fishermen

A farmer or a fisherman is given the privilege of averaging his income over a five-year period, providing the taxpayer's chief source of income has been from farming or fishing during the current tax year, known as the

"year of averaging", and the four immediately preceding years for which he has filed returns of income as required by the Act 2/. The averaging method available to this group is an example of simple or block averaging. In effect, taxes are computed annually upon each year's income as determined in the normal fashion. At the end of a five-year period, income for that period is totalled and pro-rated equally over the five years and personal allowances are deducted for each year. Tax is then computed at the rates for each year on the amount of the resulting taxable income for that year and these taxes are totalled. This total is then subtracted from the total tax actually paid in respect of the five-year period and a refund may be claimed for the difference. There is no requirement that this difference must exceed a stated minimum and, because this type of averaging can never be disadvantageous to the taxpayer, taxpayers normally elect to average in the year in which they are eligible to do so. It is our understanding that the introduction of these averaging provisions has not added in any material way to the burden of administering the Income Tax Act.

Authors

The Income Tax Act permits the spreading back of income earned from the sale by an author of the copyright in a work which took him more than a year to produce 3/. The permissible spread-back period is related to the number of years it took to complete the work, but in no case is the period allowed to exceed three years. Thus, if an author sells the copyright to a literary work which took him five years to complete, he may elect to include one third of the proceeds in his income in the year of sale and one third in each of the two immediately preceding years.

Relief is provided for authors involved in literary, dramatic, musical or artistic work, but it does not apply to income realized as a result of scientific achievement after years of research; nor does it cover the income of inventors. It is interesting to note the words of the Minister of Finance when he appeared before the Standing Committee on Banking and Commerce in

1947: "We have had no representation from inventors. The authors asked for it and made what seemed to be a sound case." 4/ The restricted coverage of the provision appears, therefore, to have resulted largely from the absence of pressure from other occupational groups.

While no one would deny that some farmers, fishermen and authors are subject to extreme fluctuations in income, unquestionably there are taxpayers in other occupations who suffer as much from the same phenomenon. Actors, musicians, consulting engineers, architects, professional athletes, construction contractors, inventors, and so on, may, as groups, be less subject to variation in income than farmers, fishermen and authors, as groups, but undoubtedly there are members of the former groups that have variations that are as frequent and as wide as those of any member of the latter groups. Equity requires equal treatment of individuals in the same circumstances, not equal treatment of groups of individuals when there are significant intra-group differences.

The relief available to farmers, fishermen, and authors should either be withdrawn or made available to all.

Lump Sum Payments

The Income Tax Act at present provides special tax treatment for a variety of lump sum payments 5/. These payments may, at the option of the taxpayer, be excluded from ordinary income in the year of receipt and subjected to a special rate of tax. Briefly, the following income is eligible for such election:

1. A single payment made out of a pension fund upon the death, withdrawal or retirement of an employee, or on the winding-up or amendment of the pension plan.

2. A single payment in recognition of long service made to an employee on his retirement and not made out of a superannuation fund.

3. A single payment pursuant to an employee's profit sharing plan in satisfaction of all the payee's rights under the plan.

4. A single payment pursuant to a deferred profit sharing plan upon the death, withdrawal or retirement of an employee.

5. A payment or payments made by an employer to an employee or former employee on retirement in respect of loss of office.

6. A payment or payments made as a death benefit.

The amount on which the special tax can be paid is limited by reference to the number of years of service or the number of years in which the taxpayer was a member of a particular plan.

If the election is made, the taxpayer will pay, in addition to any other tax payable for the year, a special tax on the lump sum payments. This special tax will be equal to the proportion of those payments that the aggregate of the taxes otherwise payable by the employee for the three years immediately preceding the taxation year is of the aggregate of the employee's income for those three years. It will not always prove to be to the benefit of the taxpayer to make the election; and accordingly it is necessary to make the requisite calculations before deciding to elect.

Although the above types of lump sum payments are significantly different from one another, the legislation provides only one relief measure. This being so, arguments could be made for the extension of some type of relief for all forms of lump sum or fluctuating income. Indeed, as long as the piecemeal system of relief continues, there will justifiably be continuing pressure not only to provide more and varied relief but also to alter or add to the methods by which such relief is granted.

The major criticism of this relief measure is that the tax rate applicable to this type of income is determined by reference to other income without adding to the other income the lump sum income, which would

tend to increase the marginal rate. Moreover, the rate of tax to be applied is determined as a percentage of the income, not taxable income, thus affording further relief.

Business Losses

A taxpayer carrying on business is permitted to apply losses from the business against his other income in that year. To the extent that business losses exceed other income, they remain available to reduce business income of the immediately preceding year and the next five succeeding years 6/.

Stock Options

Where an employee of a limited company is given the right to acquire shares of the company at a price which is below the market value of such shares at the time of exercise, on exercising the option the employee is deemed to have received a benefit by virtue of his employment equal to the difference between the purchase price paid and the value of the shares at the time of acquisition. This benefit is treated as income in the hands of the employee, but is subject to tax at a special rate. The special rate of tax applicable to the benefit is the average rate that tax has borne to income (not taxable income) for the preceding three years, minus the lesser of 20 per cent of the benefit or $200. 7/

The criticism made in respect of the relief provisions for lump sum payments applied even more strongly here until recently, because the rate of tax payable on the benefit was reduced by 20 per cent (presumably in recognition of the fact that the cost of the benefit is not deductible from the company's taxable income). However, as a result of an amendment in 1966, the amount of the reduction from the average rate was limited to $200.

Recapture of Depreciation and
Revaluation of Inventory

Where a taxpayer is carrying on business, the sale of some or all of

the depreciable assets of the business may result in the recapture of a substantial amount of depreciation, which is income in the year of recapture. Similarly, if inventory is revalued in accordance with the requirements of section 14(2), an increase may be made in the income of a taxpayer under section 43A. The Income Tax Act provides a measure of relief from these rules by permitting tax to be paid on a special basis 8/. The effect is to allow a spreading of the income over a period of not more than five years immediately preceding the year in which the recapture or revaluation takes place. The period varies according to the length of time before the year of recapture or revaluation during which the taxpayer, if a corporation, has carried on business in Canada or, if an individual, has been resident in Canada. The tax payable is the tax that would be payable for the year in question if the income did not include any amount for recapture or in respect of a revaluation of inventory, plus a special tax equal to the aggregate of the amounts by which the taxes for the preceding years would have been increased if the recaptured amount or the amount added to income by a revaluation of inventory had been spread equally over those preceding years. In other words, the amounts in question will be spread, for tax purposes, over the number of years applicable.

Summary of Present Treatment

From this description of the main existing provisions, it can be seen that the present Canadian legislation recognizes the problem inherent in receipt by taxpayers of lump sum amounts or fluctuating income, and in some cases does attempt to provide alleviation. This is done through three distinct methods: the general averaging provision, restricted to income of farmers and fishermen; the special rates of tax applicable to income from exercising stock options and certain types of lump sum payments; and the spreading back of income over prior years, applicable to the income of authors from the sale of copyrights and to the income from recapture of depreciation or revaluation of inventory 9/. The treatment of business

losses does not fall into these categories and is dealt with in greater detail in Chapter 22.

It has been emphasized in submissions to this Commission that the present relief measures do not adequately meet the needs of the general body of Canadian taxpayers. In addition to a number of submissions calling for averaging relief in respect of specific kinds of income or of specific groups of taxpayers, a general averaging provision applicable to all individual taxpayers was suggested in several submissions.

TREATMENT IN OTHER COUNTRIES

Lump sum and fluctuating income is a problem in all countries where there is a steeply progressive personal tax rate structure. It is useful to consider the general methods of relief and the variations of these methods found in several countries.

Special Rates of Tax on Irregular Income

In Austria, a taxpayer's "extraordinary" income, such as a lump sum payment for work which has extended over a number of years, is, at the taxpayer's request, taxed at special rates ranging up to 25 per cent. Similar treatment is afforded the German taxpayer who has specified types of extraordinary income, such as damages in respect of services, indemnities, and so on. These types of income are taxed at special rates ranging between 10 per cent and 30 per cent, the exact rate being determined by the local finance office. Different treatment of other kinds of income in Germany is noted below.

In Australia, authors and inventors are granted a reduced rate of tax on "abnormal" income, which generally consists of lump sum or abnormal payments received for royalties, patents, prizes, inventions, and so on. Tax at a specially calculated rate is also available to certain taxpayers in receipt of premium income from a long-term lease.

In Japan, a special rate of tax is determined by excluding from income four fifths of "fluctuating income", determining the rate of tax on the balance of income, and then applying this rate to the balance of the fluctuating income, defined generally as fishery income, royalties, sale of copyrights and certain other lump sum payments.

Special Deductions from Income

In Denmark, a special "deduction for additional income" is permitted a taxpayer when his income exceeds the previous year's by more than 10 per cent. The rate of deduction ranges between 20 per cent and 50 per cent of income over 110 per cent of the previous year's income. In Italy, a lump sum payment on cessation of employment is exempt from tax up to a specified amount. In the United Kingdom, a "standard capital superannuation benefit" is deductible in some instances from lump sum payments in respect of an office or employment, but not in respect of the loss of such office or employment.

Spreading Income Back
Over Prior Years

In Germany, a taxpayer receiving in any tax year, for personal services rendered, compensation for work done over a period of years, may allocate the compensation to the years earned, but may not go back more than three years. This rule is subject to a number of provisos which result in a limited practical application.

Sweden permits individuals, including estates or trusts, to spread over a period of years income from a wide variety of sources, including disposition of machinery and lumber, and a lump sum payment in lieu of a retirement pension. The general rule is that amounts deemed to have been earned in at least two income years shall be taxed as if received in equal parts over as many years as it had been earned, not exceeding ten years. Such income, called "accumulated income", must total a specified minimum amount and must

constitute at least one third of the taxpayer's assessable income in the year of receipt. The tax rate applied to the additional income attributed to the prior years is the rate in force for the year of actual receipt.

In the United Kingdom, authors of literary, musical or artistic work can spread the proceeds of such work back over a maximum of three years; somewhat similar relief is provided for income from personal services earned abroad, and proceeds of sale or licence of a patent. There are slightly more generous provisions for the spreading back of lump sums received as termination pay. Australia has a special provision for spreading, generally over a five-year period, income received from the disposal of inventory not in the ordinary course of business. In India, authors may spread back over prior years income received from copyrights, royalties, etc., in a manner similar to that used in the United Kingdom.

Discretionary Relief

Indian tax law provides that in the case of certain types of income, such as lump sum receipts out of special funds or received on termination of employment or loss of office, the government may grant relief, but the granting of the relief and the mode of the relief are entirely at the discretion of the government. This is similar to the situation in Germany described above, where governmental discretion plays a part in the determination of the special rate of tax on extraordinary income.

General Averaging

In Switzerland, the federal defence tax, the basic income tax of the Confederation, is determined for two years at a time and is based on the average of the two accounting years preceding the year of assessment, with special commencement and cessation provisions. This averaging is available to all individual taxpayers.

In Australia, persons engaged in "primary production", that is, production resulting directly from the cultivation of land, may elect to average their entire taxable income over the base year and the four preceding years. A loss is treated as zero income, but may be carried forward to reduce income of a subsequent year.

In the United States, a general averaging provision was introduced in 1964. Because this is the most recent attempt on the part of any country to find a solution to the problem of fluctuating incomes, and because tax reforms in the United States are of particular interest to Canada, the scheme merits consideration in some detail.

The President of the United States in his 1963 Tax Message had the following to say about the proposed introduction of a general averaging provision:

> "I have instructed the Secretary of the Treasury to present to the Congress as part of this program an income averaging provision. It will provide fairer tax treatment for those who receive in a single taxable year unusually large amounts of income as compared to their average income for preceding years.
>
> "The proposal will go beyond the narrowly confined and complex averaging provisions of the present law and will permit their elimination from the Internal Revenue Code. It will provide one formula of general application to those with wide fluctuations in income. This means fairer treatment for authors, professional artists, actors and athletes, as well as farmers, ranchers, fishermen, attorneys, architects and others."

The averaging provision is available to a taxpayer whose ordinary income for the year, that is, exclusive of capital gains, wagering gains, gifts and bequests, etc., is more than one third higher than his average income for the prior four years 10/. The provision does not apply unless the excess amount is more than $3,000. This excess is taxed in an amount equal to five times the additional tax which would be payable on one fifth of the excess. The tax on the excess amount is then added to the tax on the balance of the taxpayer's current income to determine the total tax due for the year. This procedure, in general, results in slightly less

relief than an actual spreading of the excess income over a five-year period, and obviously still less relief than if all the income were averaged. Because it operates entirely in the current year, however, it does not require the amendment of tax returns or recomputation of tax for prior years. This greatly simplifies the administrative problem. The actual steps involved in the computation of tax in the applicable averaging year are as follows:

1. The average income for the prior four taxable years is determined.

2. The prior four-year average is increased by one third to produce a base income, the amount not subject to averaging.

3. The amount of base income is subtracted from current income to determine the excess amount which will be subject to averaging, that is, "averageable income", providing it exceeds $3,000.

4. The tax is computed for an amount of income equal to base income plus one fifth of the averageable income.

5. Tax is computed for the amount of base income alone and subtracted from the tax determined in step 4.

6. The difference between the two taxes determined in steps 4 and 5 is multiplied by five to provide the total tax on the averageable income.

7. The total tax on the averageable income computed under step 6 is added to the tax on the base income alone computed under step 5, to give total tax liability for the year.

An important feature of the United States averaging scheme is that it does not give relief to taxpayers who have experienced reductions in their incomes. While undoubtedly an administrative convenience, the requirement that "averageable income" exceed $3,000 seems to us to rule out averaging for the low income taxpayer.

ALTERNATIVES TO THE PRESENT POSITION

There are basically two approaches to the solution of the problem of lump sum and fluctuating income. First, there is the method of piecemeal relief, where the problem of fluctuating tax bases is, in effect, regarded as a series of separate problems, and specific and separate remedies are provided. This is the method now in effect in Canada. The second approach regards fluctuating and irregular incomes as a general problem to be solved by the application of a general remedy, applicable to all taxpayers. We favour the adoption of a combination of the two, with general but restricted provisions that would be available to all taxpayers, but with more generous provisions to deal with special hardship situations.

A piecemeal relief system has several advantages. The system can provide specific relief for specific problem areas, and in some respects achieves its limited purpose in a straightforward and administratively simple fashion. Further, a piecemeal system is already in existence in Canada and taxpayers are accustomed to it. Finally, the present system contains within it several useful devices that could be modified or applied more widely. But we believe the advantages of the piecemeal system are definitely outweighed by the following disadvantages:

1. There are many reasons for lump sum and fluctuating incomes, and it would be impossible to provide adequately for all these different circumstances in a system geared to a series of special relief measures.

2. The problem of fluctuating income is apparently fairly widespread, and the present system cannot provide general relief. With a great widening of the tax base this difficulty would be even greater.

3. The present measures provide different degrees of relief for different types of income and are therefore inequitable.

4. As long as there are separate relief measures for specific types of

income or specific vocations, there would be continuing pressure to have the law changed to include other types of income or vocations.

5. Special relief measures tend to complicate the tax legislation. This would give the well-to-do and informed taxpayer an advantage over other taxpayers.

For all these reasons, we believe that the Canadian tax system should have general averaging provisions available to all taxpayers.

In our investigation of the alternative relieving provisions that might be introduced, we have placed great emphasis on the need for methods that had the following characteristics:

1. They should be made available on an optional basis.
2. They should be neutral among types of gains.
3. They should be administered with relative ease.
4. They should allow forward as well as backward averaging.

Many methods of relief were considered in the light of these objectives. We examined the provisions now available in Canada, modifications of the existing provisions, the methods used in other countries, and a number of proposals that have been made by our research staff and by public finance authorities. Several of these alternatives, in addition to those already described, warrant a brief comment.

Progressive Averaging

Under a progressive averaging plan the total sum of taxes paid over the averaging period, which might be a lifetime, should equal the total taxes that would have been paid had the cumulative average income, including the current year's income, been received in equal instalments in each year of the averaging period. Taxes due under this plan could be computed by multiplying the tax due on the current year's cumulative average income by the number of years in the averaging period, and subtracting from this

amount the taxes already paid for earlier years of the averaging period computed in a similar manner 11/.

A variation of this system is to divide the life of a taxpayer into three or four periods, for example, from birth to majority, majority to age 35, age 36 to 65, and then age 66 to death. A progressive averaging system differs from the moving average system discussed below because it does not involve dropping an earlier year as each later year is added to the base.

We rejected progressive averaging not only because of its administrative complexity, but also because we could see no justification for using a lifetime, or the lengthy periods described above, as the interval over which income should be measured.

Moving Average

Under a moving average, tax for a given year is computed by reference to the average income for the current year and the preceding years of the averaging period. That is, tax on the income for the first year of the period would be paid. The tax for the second year would be based on the average taxable income for the two years, and that for the third year on the average taxable income for the three years. This procedure would be continued for the period of time established as the averaging period and, upon reaching the end of that period, the first year would be dropped and the current year added.

If it were made available on an optional basis we would have no fundamental objection to the use of a moving average as the method of relief. Indeed, because each year affects average income for the sequence of years of the averaging period, the moving average creates fewer uncertainties for the taxpayer than the block average approach. Under the latter approach the taxpayer has to decide whether or not he should "use up" a particular year, for each year can be included only once in the average. However, the

moving average is slightly more complicated than the block average, and the advantages do not seem great enough to warrant the change from the block approach which is now in use for farmers and fishermen.

Deferment of Tax

Under this option, the taxpayer would be permitted to spread his payment of taxes on lump sum payments forward over a period of years. This method was actually used in Canada in 1946, in respect of certain lump sum payments. It was abandoned after a very short experience, presumably on the grounds that there were too many circumstances, such as death or bankruptcy of the taxpayer, in which the government would be unable to collect the tax due. This difficulty would be avoided if the taxpayer were required to post a bond, or the government were provided with some other form of security. We recommend in Chapter 17 that taxpayers in receipt of non-cash gifts against which the donee cannot borrow should be given an extended period of time for the payment of the tax which is attributable to the gift; we also recommend that interest should be charged and safeguards adopted to ensure payment.

Carry-over of Unused Personal
Exemptions or Tax Credits

This method would permit a taxpayer who did not utilize his full personal exemptions or tax credits in a tax year to carry over to a subsequent year or years the unused portion of these exemptions or credits. Unused exemptions or credits are almost invariably applicable to taxpayers in the lower income tax brackets, and the introduction of such a measure might well mean that many such taxpayers would be relieved of all or a substantial portion of their taxes, perhaps for a period of years. The approach to block averaging that we recommend would, in effect, allow the carry-over of personal tax credits within the averaging period.

Income Adjustment Accounts

Some taxpayers have substantial income for a limited period relative to their probable future income, for example, some professional athletes or other entertainers in their peak years. Yet to offer special relief only to named occupations is clearly discriminatory; and to allow all taxpayers long averaging periods is not feasible on administrative grounds.

There is, we believe, a method of providing a form of long-term forward averaging that is administratively workable. The method would involve the use of what we have called Income Adjustment Accounts. These accounts, in the form of non-interest-bearing government deposits, would provide a method of granting relief to all taxpayers rather than to certain taxpayers for special circumstances. The Income Adjustment Accounts would permit a taxpayer to deposit part of his income with the government and deduct that amount from his income for the year in which the deposit was made. Withdrawals from these Accounts would be added to income in the year withdrawn. They would thus provide a form of "do it yourself" forward averaging without the drawbacks of most forward-averaging schemes. The taxpayer would surrender his economic power and postpone his tax liability, but he would "pay" for the postponement privilege by forfeiting the income that otherwise would be earned on the amount deposited. The system would therefore be self-policing. If future income did not fall, so that lower marginal rates could not be applied in the future, the depositor would have paid a postponement fee in the form of forgone income. It is this need for a postponement fee that has led to our recommendation that <u>no</u> interest should be paid on these deposits. In addition we feel that the payment of any interest, even at a nominal rate, would provide the Income Adjustment Accounts with an unfair competitive advantage over banks, trust companies or other institutions receiving deposits <u>12</u>/.

These Accounts would not be without their limitations and problems.

There would have to be a minimum time period before a deposit could be withdrawn to prevent a short-term deposit over the year end being used to postpone tax for one year. It would be important to prevent taxpayers borrowing against their Income Adjustment Account deposits, and therefore deposits in the Accounts would have to be non-assignable. They would be of no assistance to those who receive income in the form of non-marketable assets. Although this form of averaging would therefore be inadequate as the only form of relief, we believe it would have many advantages as a supplement to the traditional averaging techniques if a few safeguards were applied.

Registered Retirement Income Plans

In Chapter 16 we recommend that contributions to defined Registered Retirement Income Plans should be deducted from current income within limits related to the annual income that could be obtained under such a plan from age 65. In addition, the investment income or property gains generated would not be taxed when received by the trustees of the plans. Payments from the plans would be brought into income when received. There would be few restrictions on the assets that could be held by the plans, and therefore it would be possible to contribute real property to them. The deferment of tax on the income generated by the assets held by such plans until received by the taxpayer, would continue to constitute an extremely important concession designed to encourage low and middle income individuals and families to provide for their retirement.

These Registered Retirement Income Plan provisions also provide a liberal and flexible method of averaging for low and middle income tax units that receive large lump sums, such as gifts, bequests or windfalls. If the individual or family had not already reached the limit imposed on contributions to such plans, and it is extremely unlikely that low income people would have done so, given the limits we suggest, a substantial contribution could be made in one year and the contribution deducted

from income. Any withdrawal would be brought into income, but the penalty which would normally apply on withdrawals before the age of 60 would not be applicable if the withdrawals did not increase total income for the year over $7,000. Further discussion of these plans is contained in Chapter 16.

Treatment of Losses

The carry-back and carry-forward of realized losses, in order to reduce net gains of earlier or subsequent years, provides a method of income averaging. Although we think it would be necessary to impose some restrictions on the deductibility of losses, primarily to ensure that personal consumption expenditures are not deducted, our basic proposal which is discussed in Chapter 9 would allow most losses (to the extent that they exceed other income for the current year) to be carried back for two years and forward indefinitely. These losses should be deductible from net gains of all kinds. Our proposed treatment of losses would make it possible to level out income more than has been possible under the present tax system.

Asset Revaluation

Permitting the revaluation of some assets to their demonstrated market value at the discretion of the taxpayer also provides a method of averaging. We recommend that a taxpayer should be permitted, without actually realizing gains or losses, to pay some of his potential tax liability on his unrealized property gains in low income years, and obtain relief by including unrealized losses in high income years. In Chapter 15, we discuss the optional revaluation provisions that we recommend.

RECOMMENDED TREATMENT OF LUMP SUM AND FLUCTUATING INCOMES

It should be made clear at the outset that the recommendations in this chapter should be applicable only to Canadian residents. To permit non-residents the relief contemplated for irregular income would raise serious administrative problems.

Block Averaging

The advantages of a general averaging provision over a piecemeal system of relief have been outlined. In the belief that the problem of lump sum and fluctuating incomes is sufficiently widespread to require a more adequate method of granting relief than now exists, we recommend that a block averaging provision should be introduced that would be available to all taxpayers. However, to reduce the administrative problems that such a provision would entail, there should be restrictions, at least initially, based on both a minimum fluctuation in income and the minimum tax saving that would have to be obtained before the block averaging provision could be employed by a taxpayer. We expect that it might be possible at some future time to remove these restrictions and to allow everyone to average regardless of the amounts involved. However, we suggest the use of limitations initially to ensure that the provision can be easily administered. Such a general block averaging provision would provide the same kind of treatment for all taxpayers whose incomes fluctuate frequently, or who move quickly from a low income bracket to a high income bracket or vice versa. It should be emphasized that our recommendation would allow averaging whether income was rising <u>or</u> falling. It would also provide a means of mitigating the severity of the tax burden in respect of lump sum income payments of any kind which are received by a taxpayer. In order to provide the taxpayer with an adequate period of time in which to determine his status in relation to any change in his tax unit, to carry back losses of subsequent years, if applicable, and to decide which years should be averaged, there should be an extended period for filing amended returns if the only change is to make an election to average and to claim a refund based on that election. However, in order to avoid undue deferment of election, no interest should be payable on such a refund.

The block averaging system has the advantage of already being an accepted part of Canadian tax legislation, and it appears to have operated to the reasonable satisfaction of both taxpayer and administrator. We do not think

that the advantages of the more complicated moving average system discussed above would justify its adoption at this time. As experience is gained by taxpayers and by the administration, adoption of more refined techniques should be considered.

We suggest that the block averaging provision be made available to all resident taxpayers. We believe it is desirable to have all tax units treated in a similar manner, and with a few exceptions that we deal with later in this chapter, to accord similar treatment to all kinds of fluctuating or lump sum income. Adoption of a general averaging provision would permit the repeal of all of the existing piecemeal provisions.

Period of Averaging. It is necessary in a block averaging system to specify over what term or period of years income can be averaged. The period must be long enough to level effectively the peaks of income, but not so long as to create an impossible administrative task in recomputing tax on many returns for many earlier years. Three-year averaging would appear to be the minimum that would take care of most income fluctuations; five-year averaging is probably the maximum administratively feasible period. At present, farmers and fishermen are entitled to use a five-year block average. In order to avoid worsening the position of these two groups and because we think it is practical, given the methods of data storage and handling now available, to treat all taxpayers in the same way, we recommend that a five-year rather than a three-year averaging period should be adopted. Only consecutive years, with no years omitted, should be included in an averaging period. No overlapping of years in different averaging periods should be allowed except upon death or on giving up Canadian residence, for the reasons given later in this chapter. Only years in which the taxpayer had been resident in Canada should be included in an averaging period.

The five-year period should be treated as the maximum number of years that could be averaged. Taxpayers should be permitted to average over shorter periods if they wished to do so.

Restriction Related to the Size of the Tax Saving. To keep the administrative problems of a general averaging scheme within bounds, relief in respect of lump sum and fluctuating incomes should be provided, at least initially, only where fluctuations in the tax liabilities are substantial. Therefore we recommend that the right to average should only be available when the income in the lowest income year of the averaging period is less than 75 per cent of the income in the highest income year of the period. In addition, tax relief should be allowed only to the extent that the reduction in tax resulting from the averaging procedure exceeded $50. These restrictions would eliminate small claims and would restrict the use of the provision to those with material fluctuations in income.

Method of Calculation. The calculation to determine the tax credit (or refund), for those with fluctuations of income in excess of the limit, should be as follows:

1. For the years being averaged, the incomes, tax credits, and tax payable would each be aggregated.

2. An appropriate special averaging rate schedule would be used to arrive at the tax payable before tax credits on the aggregate of the incomes after loss carry-over and charitable and medical deductions.

3. The total of the tax credits claimed in the years concerned would be deducted from the tax payable computed in 2.

4. The amount obtained in 3 would be compared to the total of the actual taxes paid for the years concerned. If the actual taxes paid were less than the amount in 3, then the fluctuation of income would not have been sufficient to produce a benefit under the averaging procedure. If the actual taxes paid exceeded the amount in 3, then the difference would be claimed as a tax credit from tax otherwise payable in the year or as a refund.

The use of the special averaging rate schedules would mean that only one computation of a new tax payable would be necessary, instead of a new computation for each year averaged. Changes in tax rates would be reflected in these schedules, so that a taxpayer would not have to refer back to the rate schedules of prior years. There would be separate individual and family rate schedules for the two-, three-, four- or five-year periods eligible for block averaging. The averaging schedules would represent an aggregation of the individual schedules for the years concerned. Thus, if for each of five successive years $10,000 of taxable income was subject of $2,260 in tax and the next $2,000 of taxable income was taxed at 35 per cent, the five-year rate schedule would show that $50,000 of taxable income was subject to $11,300 in tax with the next $10,000 of taxable income being taxable at 35 per cent. In addition, and to save a separate computation, the rate schedule would include in each of the income tax totals a further basic amount of $50, this being the amount of the reduction in tax that would not be refundable.

There are alternative methods of computing the tax adjustment under a block averaging procedure. For example, it would be possible to establish a minimum income fluctuation and to only allow the amount in excess of such fluctuation to be averaged. However, we feel that the procedure we have recommended would limit the election to those cases where it would be of some importance to the taxpayer and would reduce the necessary computations to a minimum.

Starting and Ending Points. The starting point for block averaging would be the first full year in which a particular tax unit came into being. In Chapter 10, we recommend that tax units would be formed at the beginning of the year in which any of the following circumstances occurred:

1. When an individual lost his or her dependant status otherwise than by marriage, an individual tax unit would be formed.

2. When a family tax unit was formed through marriage.

3. When a divorce or a legal separation took place and each spouse formed a new tax unit; if a spouse retained custody of a dependent child or dependent children this would be a new family unit; otherwise it would be a new individual unit.

4. When an unmarried woman had a child and retained custody of the child a new family unit would be formed.

5. When an unmarried individual adopted one or more children a new family unit would be formed.

6. When an individual or a family became resident in Canada an individual tax unit or a family unit would be formed.

The end of a period for block averaging should not be later than the termination of the taxable unit. In Chapter 10, we also recommend that a family unit would terminate when any of the following circumstances occurred:

1. The death of a surviving spouse who had no dependent children.

2. The remarriage of a surviving spouse.

3. The divorce or legal separation of spouses.

4. If all members of a tax unit ceased to be resident in Canada and did not elect to continue to be taxed as Canadian residents.

5. If the family unit consisted only of dependent children and the last of those children ceased to be dependent through marriage or otherwise, or died.

An individual tax unit would terminate in the event that the individual died, ceased to be resident in Canada, married or acquired a dependent child or dependent children through birth or adoption.

Because the first year of an averaging period could not be earlier than

the first year in which a particular tax unit came into being, newly independent individuals would not be entitled to include in the averaging period years when they were dependants and had no taxable income. Similarly, recently married couples would not be entitled to include in the computation years when they were single and taxable at higher rates.

Where one of the spouses in a family unit had filed separate returns for consecutive years, he or she should be entitled to make an election for the averaging of income for those years. However, a family unit as a whole should be entitled to average income only for consecutive years in which joint returns were filed.

When the family unit has been reduced to one member, the unit would continue but, as we have said, tax liabilities would be determined on the individual rate schedule. It should be provided that when block averaging has been applied under this circumstance the tax would be determined on the basis of the individual rate schedule for the whole averaging period. This would restrict the advantage that could be derived from averaging on the death of one spouse where there were no dependants.

We recommend that on the death of a taxpayer there should be realization of his property gains except for property transferred to members of his continuing family unit. We also recommend a deemed realization of property gains under certain other circumstances. This could result in substantial income in that year. To ensure that the income for the year in which such a realization or deemed realization took place could be averaged over five years, we suggest that, on the termination of a taxable unit because of death or ceasing to be resident in Canada, backward averaging should be permitted for the previous five-year period, even though one or more of those years had already been used in an earlier block averaging election. In this case the income to be taken into account for each year which was in the previous block averaging period would be the average income for that period and credit would be given for the tax calculated under the previous averaging which is attributable to that income.

It should be pointed out that by relating the block averaging period to the life of the taxable unit rather than to the sources of income of the members, there would frequently be large refunds in the early years of retirement. However, if averaging were limited to working years only, some taxpayers might be able to avoid the limitation because of the difficulties in defining retirement. We also believe a worth-while social purpose would be achieved by this form of relief to persons who experienced a sharp drop in income on retirement.

Moreover, our approach would permit families to average their incomes after the death of the income-earning spouse and, in effect, to obtain a tax rebate for earlier years of higher income.

Treatment of Losses. Where losses had been incurred by a tax unit prior to the commencement of the averaging period, these losses would be available to reduce income for one or more years in the averaging period. In this way such losses would be taken into account in the block averaging calculation. Similarly, if losses were incurred in one or both of the two years following the end of the averaging period, such losses would be eligible to be carried back so as to reduce the income for one or both of the last two years in the averaging period. We recommend that the time for making an election to average should be extended sufficiently to permit the carry-back of such losses.

If a loss occurred in a year which was within the averaging period, this loss could be applied in the usual way to reduce income for other years which may be prior to or within the averaging period or both. Any such loss, to the extent that it had not been fully used up by the end of the averaging period, should be allowed as a deduction in computing the aggregate income for the averaging period. The amount of the loss so deducted would not be eligible to be carried forward to subsequent years. It should be noted, however, that a taxpayer would not be required to make an election to average his income and if he did not do so the loss would continue to be available for carry-forward and application against income of subsequent years.

Comparison with United States Provision. Although we recognize that the United States approach has some administrative advantages over our block averaging proposal, we think that, on balance, our proposal is superior to the United States method. In particular, we think that there is as much, if not more, justification for giving relief when income declines sharply as when it rises sharply. The conditions under which the United States method bestows relief are exceedingly capricious. If the United States method were modified to provide relief when income changed in either direction, and if the tests of eligibility were reduced, we would consider it a satisfactory alternative to our proposal.

Administration. We do not wish to minimize the magnitude of the additional work that adoption of our proposal would create. It would mean an increase in the work load of the administration and more record keeping by taxpayers. We are convinced, however, that the additional cost would be fully justified.

Income Adjustment Accounts

On equity grounds we think there is as much reason to allow a taxpayer to take his expected future income into account in determining his current tax liability as to allow him to take his past income into consideration. This is in general ruled out under block averaging. Moreover, by restricting the block average to a five-year period, the longer swings in income, such as the substantial earnings of professional athletes, actors, and writers in their peak years, may be given inadequate relief. To overcome these two limitations of the block averaging scheme, we also recommend that a system of Income Adjustment Accounts be adopted. Like block averaging, these Accounts should be made available to all taxpayers on an optional basis. It should be noted that by combining both of these averaging devices it would be possible to average one year's income over a substantial period. Part of the income for the year could be deposited in an Income Adjustment Account and averaged forward for an indefinite number of years, while the other part of the income could be averaged back five years. Income Adjustment Accounts should be non-

transferable, non-negotiable and non-interest-bearing deposit Accounts administered by the government.

Deposits into Income Adjustment Accounts made during the calendar year, and within sixty days of the end of the calendar year, should be made deductible from income for that year for tax purposes.

Limitations of Reductions in Current Income. We would not limit the amounts of deposits in these non-interest-bearing Accounts. By allowing the deposit of all gains on disposition of property, the low or middle income taxpayer with infrequent gains could spread the gain over a number of years and reduce his tax accordingly, while the taxpayer who regularly received such gains would have no advantage. The same would be true of other lump sum receipts, such as gifts or gambling gains.

Speculation. Unless the use of the Income Adjustment Accounts was restricted, there would be some danger that taxpayers might use them when they expected that personal income tax rates might decline, or as a means of temporarily deferring payment of their tax liabilities. They could reduce their incomes by making deposits just before the end of the year, in the knowledge that they could withdraw the funds early in the subsequent year, and so use the Income Adjustment Accounts to speculate or to defer taxes at virtually no cost except the loss of interest on their funds over this short period. To reduce the profitability of such a procedure it would be necessary to require that the balance in a taxpayer's account could not be less than the sum of the deposits made within the previous twelve-month period.

The use of Income Adjustment Accounts would imply that all income was taxed at some point, but that the time pattern of income received and of income subjected to tax could be different. The taxpayer would not, however, gain by deferment of tax as such, because the provisions of such Accounts would be designed so that the taxpayer who made deposits when his marginal rate of tax was 50 per cent and made withdrawals when his marginal rate was

also 50 per cent would suffer a loss, because he would receive no income thereon, as compared with the taxpayer with the same income experience who made no deposits or withdrawals but paid his tax at the time he earned his income. The man with fluctuating income could, of course, gain by using the Accounts, although where small changes in marginal rates were involved, the gain would be at least partly offset by the lack of income from the funds deposited. The government would obtain the use of the money on an interest-free basis and accordingly would not suffer by deferment of the tax liability.

Withdrawals. Withdrawals from Income Adjustment Accounts should be added to taxable income in the year in which they were made. It would be prudent to provide that sums withdrawn should be subject to a withholding tax. The evasion problem should not be serious, because the administrator of the Accounts would report all withdrawals. A withholding rate of 30 per cent should be acceptable. Of course, the amount taken into income by the taxpayer should be the gross withdrawal before deduction of withholding tax, and credit would be given, if necessary in the form of a refund, for tax withheld at source by the administrator.

It must be borne in mind that the purpose of the Income Adjustment Accounts is to allow the taxpayer to spread his income more evenly to escape the high marginal rates that would apply in years of unusually high income. It is intended that taxpayers defer but not escape tax on the deposited income. Therefore, the general rule should be that funds deposited by a tax unit must eventually be taxed as the income of the same tax unit. In particular, the deposits should not be transferred to beneficiaries outside the unit without being subject to tax in the hands of the depositing unit. However, to avoid creating barriers to marriage and divorce, we would not require individuals to bring their Income Adjustment Account deposits into the income of the terminating individual tax unit before marriage, nor would we require spouses to bring such deposits into the income of the terminating family tax unit before divorce or legal separation.

When a taxpayer emigrated, any balance that remained in his account would have to be brought into income in the last year he filed a return as a Canadian resident. This procedure is discussed in more detail in Chapter 15. If he satisfied the administration that he would meet his tax liabilities, the taxpayer could withdraw the deposit in the usual manner whenever he chose to do so.

To limit the possibility of the pyramiding of tax liabilities at death, we believe it would be desirable to require that all individual tax units withdraw all deposits on or before reaching the age of 60 and that family units should withdraw all deposits on or before the date on which the youngest member of the unit reached the age of 60. Such a provision would prevent most units from postponing their tax liabilities until death.

Modification of Income Adjustment Accounts. A modification would be necessary to accomodate the aggregation of dependant and family income. The general rule should be that Income Adjustment Account deposits made by a tax unit must, on withdrawal, be brought into the income of the same tax unit, in order to prevent tax-free transfers of property between units. We recommend that a further exception should be made to this rule to provide some flexibility with respect to the aggregation of the dependant's income with family income.

As we pointed out in Chapter 10, we believe that the system should require dependants in receipt of gifts from outside the family, and in receipt of employment or business income earned at arm's length in excess of the $500 exemption, to aggregate all or part of this income with the income of the family for tax purposes. However, because the dependant and the family may not consider these receipts to be income available for current consumption, we suggest that the dependant should be able to deposit these amounts in special Income Adjustment Accounts in the year they were received. The deposits would be made in the name of the dependant and would be deductible from the income of the family. The family would not be required to bring these deposits into income at the time the dependant loses his or her dependant status, although withdrawals made while the dependant

is still a member of the unit would be included in the income of the family unit. Deposits could be withdrawn later and brought into the income of the tax unit of which the former dependant was then a member.

These deposits should earn interest for the period during which the depositor was dependent. Only a modest rate of interest should be paid to compensate for the fact that, in principle, the deposit should be subject to tax and only the after-tax deposit should earn a return.

Other Procedures

The two general relief measures we have advocated would meet the situations encountered by most taxpayers most of the time. But we recognize that it is important for acceptance of the comprehensive tax base that generous averaging be provided in all the circumstances which, although infrequent, can nevertheless produce hardship. We therefore suggest the adoption of a few special relief measures. What we have tried to do is to give special relief in special circumstances and not to special groups.

<u>Deferment of Tax Payments</u>. As we envisage the Income Adjustment Accounts, only cash deposits would be accepted. For those who received non-cash income, had no cash on hand and could not borrow, the Accounts obviously would not be helpful. Taxpayers would, of course, be able to utilize the block averaging provisions for this kind of income. However, a liquidity problem could still exist and for this reason we suggest that those in receipt of gifts or other income that is in a non-liquid form should be allowed, on the provision of adequate security, to pay the tax on this part of their income, with interest, over a period of, say, five years. This is discussed in Chapter 17.

<u>Registered Retirement Income Plans</u>. There are some other procedures, which we discuss in greater detail later in this <u>Report</u>, that will also serve to even out income fluctuations.

In Chapter 16 we discuss the details of our proposals for Registered Retirement Income Plans. The important aspect for averaging purposes is that the only limit on annual contributions we propose is one that would set the maximum amount that could be accumulated in the plan at any one time. Thus, a taxpayer who received a relatively large amount of income in one year and had not already made full use of his Registered Retirement Income Plan, could make a substantial contribution to such a plan and deduct the amount of such a contribution from income.

In Chapter 16 we also discuss the taxation of government and private insurance plans that provide for the continuance of income when unemployment or accident reduces or ends the earning capacity of the taxpayer. For these types of plans, such as workmen's compensation, unemployment insurance, supplementary unemployment insurance, and sickness and accident insurance of a salary continuance nature, we recommend that premiums should be deductible and benefits taxed in full when received.

Although these provisions are not averaging devices, they would encourage a form of income spreading to maintain a certain minimum level of income. Thus, they would encourage the individual himself to provide for periods when his income might otherwise be less than average.

Property Revaluations. In Chapter 15, we suggest that holders of property should be permitted to revalue such property, either up or down, to reflect current market prices. Although we would not expect many taxpayers to revalue their property upward, nevertheless such revaluations might be advantageous in years when income was relatively low.

Registered Annuities. We also recommend that the recipient of certain kinds of lump sum payments, such as damage awards related to the loss of future income, should be permitted to exclude such amounts from income if they were used to acquire government annuities registered for this purpose. Payments from the annuity would have to begin immediately and would be included in

income in the years received. This election would be of assistance in a limited number of cases.

Income Subject to Averaging

It is useful to distinguish four measures of income:

1. Net income for the year before the deduction of losses incurred in past years.

2. Net income for the year after the deduction of losses incurred in past years.

3. Income as defined in 2 minus charitable and medical deductions.

4. Income as defined in 3 minus losses incurred in subsequent years.

We recommend that the following rules should be introduced:

The allowable medical and charitable deductions should be computed by reference to 2.

Block averaging, or any special averaging provisions on death, should apply to 4; however, it could be elected initially on the bases of 3 and if losses are incurred in the subsequent two years an amended block averaging would be filed based on 4.

Reductions of income or additions to income resulting from the use of Income Adjustment Accounts, special deposits for dependants and registered annuities would be taken into account in the determination of 1.

By relating the medical and charitable deductions to the net income for the year before the deduction of losses incurred in subsequent years, these deductions would not have to be recomputed if losses were later carried back to reduce the net income for the year or if the income for the year was later included as one of a block of years for averaging purposes. This would be an important administrative advantage. It would also mean that tax credits

unused in low income years could be deducted against the higher taxes imposed on the average taxable incomes for the block averaging period. Unused tax credits could, in effect, be carried forward within that period.

CONCLUSIONS AND RECOMMENDATIONS

1. It would be unfair to impose substantially heavier taxes on those with imcomes that fluctuate from year to year. Equity requires that some form of income smoothing be permitted. Without this, taxpayers who were able to manipulate the timing of their receipts would have an advantage over other taxpayers.

2. For administrative reasons we could not recommend the full taxation of property gains on a realized basis unless liberal averaging provisions were available; the gains might have arisen over a period of years and it would be inequitable to tax them as though they arose in the year in which they were realized.

THE PRESENT SYSTEM

3. The present system of piecemeal relief is relatively simple to administer but affords special relief to some occupations and some kinds of receipts that are no more deserving than others. Some of the relief provisions have been too generous; the problems of other taxpayers, such as professional athletes and other entertainers, have been ignored. The present averaging provisions are extremely complicated and are inequitable.

DESIRABLE ATTRIBUTES OF AN AVERAGING PLAN

4. We believe that an averaging system should have the following attributes:
   a) It should be available to taxpayers on an optional basis.
   b) It should be neutral among kinds of gains.
   c) It should permit both forward and backward averaging.
   d) It should take into account relatively few earlier years to reduce the administrative problem.

We have developed our proposals in the light of these criteria.

BLOCK AVERAGING

5. We recommend the introduction of a block averaging system which would be available to all resident individual and family tax units. The averaging period should be five years, although taxpayers should be able to average fewer years if they wished to do so. Only consecutive years, with no years omitted, should be included in the block of years for averaging.

6. Except where there has been a realization or deemed realization of property gains upon the termination of a tax unit because of death, or on giving up Canadian residence, a year once used in a block of years for averaging purposes should not be included in another block of years.

7. There should be no restriction on the kinds of income that could be averaged or on the direction of the fluctuations in income.

8. The only restriction should be that the lowest income in the period must be less than 75 per cent of the highest income in the period, and that the tax saving brought about by block averaging would be reduced by $50. We suggest these restrictions to reduce administrative costs. With experience and increased mechanization, these restrictions might be dropped.

9. The first year that could be included in a block of years to be averaged should be the first full year in which a particular tax unit was in being. The last year that could be included in a block of years to be averaged should be the year in which the particular tax unit terminated. Generally speaking, this would result in refunds of tax after retirement, and after the death of the income-earning spouse.

10. Losses carried forward or back from years outside the averaging period could be taken into account in computing the income which was being averaged. Unused losses incurred in the averaging period would be deductible in computing the averaged income, but to the extent they were so used by reason of an election to average, they would not be available for future carry-forward.

INCOME ADJUSTMENT ACCOUNTS

11. We also recommend a system of Income Adjustment Accounts that would make it possible for taxpayers who expect reductions in future income to reduce their current income by making non-transferable, non-negotiable, non-interest-bearing deposits with the government.

12. When used in conjunction with the block averaging system, Income Adjustment Accounts would make it possible to spread income over many years.

13. There should be no restrictions on the amount of income that could be deposited in any one year. It would be necessary to impose a few restrictions on the timing of withdrawals to prevent speculation on changes in tax rates and postponement of tax through deposits made just before one year end and withdrawn early in the following year.

14. Because the Income Adjustment Accounts would be non-interest-bearing, taxpayers would pay a price for tax postponement. This would make the system self-policing.

15. A refundable withholding tax should be imposed on withdrawals, in order to prevent evasion.

16. To prevent a conjunction of taxes at death, the use of Income Adjustment Accounts should be denied to individuals of advanced years.

17. The funds deposited in an Income Adjustment Account by a tax unit should,

with certain exceptions, be taxed on withdrawal to the same tax unit to prevent tax-free transfers of property between tax units. These funds would be taxable in a year in which all members of the tax unit ceased to be resident in Canada.

MODIFICATION FOR DEPENDANTS

18. Dependants should be allowed to make Income Adjustment Account deposits not exceeding gifts received from outside the family and the annual employment or business income earned at arm's length by the dependant in excess of the $500 exemption. These deposits should bear a low rate of interest while the depositor remained a member of the family unit. Unlike the general treatment of Income Adjustment Accounts, the family should not have to bring the dependant's deposit into family income when the child ceased to be dependent. It should be taxed to the tax unit of which the former dependant was a member at the time of the withdrawal.

RETIREMENT INCOME PLANS

19. Under the proposed treatment of Registered Retirement Income Plans discussed in Chapter 16, we recommend that contributions to such plans should be deducted from current income within limits related to the annual income that could be obtained under such plans from age 65. Withdrawals could be made before age 60 without the usual penalty applying to such withdrawals if income, including the withdrawal, did not exceed $7,000 a year. The income earned by the assets of such plans would not be taxed until paid out. Because the recommended limits are high, it would be possible for most taxpayers in receipt of a substantial lump sum to make a large contribution in that year and defer tax until retirement or until annual income fell below $7,000.

PROPERTY REVALUATIONS

20. We propose that taxpayers be permitted to revalue their property up or down to reflect current market prices. Gains could thus be brought into income in low income years and taxed at lower marginal rates.

REGISTERED ANNUITIES

21. To put those in receipt of lump sum settlements for damages or compensation for accidents on the same basis as those who received monthly payments, we recommend that such sums should be deductible from income if used to purchase registered government annuities. Payments from such annuities would be brought into income when received.

REFERENCES

1/ From information collected by the Dominion Bureau of Statistics during a 1964 survey of consumer finances, and kindly loaned by them to the Commission.

2/ Section 42.

3/ Section 80. This provision was enacted as section 3(10) of the Income War Tax Act in 1946.

4/ House of Commons Standing Committee on Banking and Commerce 1947-48, Consideration of Bill 338, p. 673.

5/ Section 36.

6/ Sections 139(1)(x) and 27(1)(e). This subject is dealt with in detail in Chapter 22.

7/ Section 85A.

8/ Sections 43 and 43A.

9/ It will be noted that there are a number of other averaging provisions, such as sections 15(2), 15(3), 37(1), 37(3), 64(2) and 85E(4). Other methods of alleviation are provided for in some of these provisions.

10/ Internal Revenue Code, sections 1301-1305, applicable to taxable years beginning after December 31, 1963.

11/ For a detailed discussion of this complicated subject, see W. Vickrey, Agenda for Progressive Taxation, New York: The Ronald Press Company, 1947.

12/ If these accounts paid interest, even at a below-market rate, private financial institutions would be at a competitive disadvantage with the government because the combined value of the tax savings and interest could well exceed the return paid on private deposits.

CHAPTER 14

EMPLOYMENT INCOME

In this chapter we are primarily but not exclusively concerned with the taxation of employees. Many of the problems discussed here relate primarily to the taxation of employees but are not confined to them. The recommendations we make with respect to the taxation of non-cash benefits and the deduction of personal expenses apply also to other taxpayers.

Income and Deduction Problems

The comprehensive tax base, like the present Act, calls for the taxation of all net gains in cash or kind derived from the performance of personal services. There are three problems in achieving this result.

First, there is the problem of determining when the remuneration paid by the employer is to be included in the income of the employee. Although the present procedure of taxing an employee on the cash basis generally poses few difficulties, there are instances when an employer will deduct an amount that is set aside for the benefit of an employee, but, because it is not immediately paid to him, the employee does not include such amount in income until it is received in a later year. The effect is to defer the payment of the tax liability, a result which we believe is inequitable and should therefore be corrected.

Second, it is extremely difficult to determine when and to whom employers provide non-cash benefits and to value these benefits on a consistent basis. Failure to enforce a law that purports to tax non-cash benefits will inevitably result in a loss of respect for the tax system, while to change the law to exclude non-cash benefits from tax would provide some individuals with an inordinate tax advantage.

Third, while employees should be able to deduct the expenses they have incurred in the expectation of generating employment income, it is imperative

that the deduction of personal living expenses should be prevented. The distinction between the two kinds of expenses is often unclear. With a multitude of employees, each with many expenses, the application of the principle to the particular facts relevant to every expense of every employee is utterly impossible from an administrative point of view.

There is no denying that these difficulties are severe; there is also no denying that the present system falls far short of an adequate solution to any of them. The present system discriminates unfairly among different employees and between employees and the self-employed.

The major discrimination among employees arises because some can arrange to receive part of their remuneration in the form of untaxed "fringe" benefits while other employees cannot. The present law provides for the taxation of such benefits, but the administration has been unable to enforce the law effectively. The unequal application of the law means that some employees do not bear their fair share of the tax burden.

With literally millions of transactions taking place every month, general provisions such as those currently on the statute books are, to a substantial degree, an empty gesture. It would take an army of assessors and a battery of courts to apply the law effectively. A system consisting of a few general but unenforceable provisions inevitably degenerates into one where a few are capriciously taxed while the abuses of the many go untouched. We are reluctant to recommend arbitrary tax provisions, but we are convinced that arbitrary provisions that err on the side of liberality and are fully enforced would provide more real (if rough) justice than general provisions that are inconsistently enforced.

The unfair discrimination between employees and the self-employed arises primarily because the self-employed can, in computing their business or professional income, deduct all reasonable expenses incurred for the purpose of producing such income. Employees, in computing their income from employment,

can only claim a few specified deductions as set forth in sections 5 and 11 of the Income Tax Act and no other deductions whatsoever. Skilled manual workers and employed professionals are particularly affected by these stringent limitations on deductions 1/.

Before discussing the major features of the present system in Canada and other countries, and our specific recommendations, we wish to make a few remarks about the approach we have adopted.

Taxation of Benefits

The tax treatment that should be accorded most benefits from employment is usually perfectly obvious. When an employer makes a contribution to an employee retirement income plan or sets aside an amount that is to be paid to an employee at some later date or pays a life insurance premium for an employee or offers attractive stock option or profit sharing plans, it is clear that the employee is being remunerated by the employer and that the employee should pay tax on this remuneration when it is received or applied for his benefit or when he has a right to receive it or when the employer establishes a non-contingent liability to the employee. More difficult problems arise with respect to the element of remuneration that may be contained in the employee's expense account or in the consumer goods and services provided the employee by his employer while performing his duties.

The difficulties in taxing amounts that are set aside or put into trust for the benefit of employees are part of the overall problem of determining when an amount is to be included in income. In Chapter 9 we expressed our belief that although the employee should, in general, only be taxed when he actually received an amount, it is necessary to ensure that such an approach does not lead to deferment of tax liabilities. Because the employer will generally be in business and therefore will be recording his accounts on an accrual basis, it is necessary to ensure that a deduction is not claimed by the payer without the amount simultaneously becoming income to the beneficiary.

To do otherwise would be to invite taxpayers to make arrangements that result in tax deferment. Therefore, we recommend that the basic approach should be to deem that an employee had "received" a benefit at the time an amount paid or accrued by the employer was deducted in computing the income of the employer.

We have adopted four basic rules for the taxation of non-cash benefits:

1. Wherever possible the recipient of a non-cash benefit should bring into his tax base what the benefit would cost if he purchased it in the market and not the cost to or revenue forgone by the employer.

2. It must be assumed that the recipient of a non-cash benefit had a choice between the non-cash benefit and the receipt of a taxable cash payment equal to the cost which would be incurred if the benefit were purchased in the market.

3. When, in the course of carrying out his work, an employee is provided with consumer goods and services by his employer, there may be an element of personal benefit. Because the market value of the personal benefit in each case cannot be ascertained on a simple and consistent basis, there should be arbitrary limits on the costs of such goods and services which are regarded as expenses of earning income. A living expense of an employee paid by an employer in excess of these limits would be deemed to be a personal benefit to the employee. Expenses over these limits should be brought into the tax base of the employee.

4. Where a common facility provides benefits in kind to a number of individuals simultaneously, the market value of the benefit provided by the facility should be included in the incomes of those who enjoy it, according to their relative benefit.

We have tried to develop enforceable tax provisions consistent with these rules.

In order to perform their duties, some employees are required by their employers to travel (as distinct from commute), to live away from home and to entertain clients or staff. An employee required to do these things may be provided by the employer with food, drink, shelter and transportation or he may be reimbursed by the employer when he incurs these expenses 2/. There will be an element of personal benefit in the following circumstances:

1. When the employee is able to enjoy, at the expense of the employer, a style of life that is materially better than he provides for himself at home.

2. When the employee's personal living expenses are reduced.

3. When the purpose of the trip, dinner, party or entertainment is to satisfy (remunerate) the employee rather than to carry out the business of the employer.

There can be no doubt that the value of the personal benefit element in these employer expenses should be brought into the income of the employee. There is also no doubt that where employer and employee are dealing at arm's length the expense should <u>not</u> be disallowed to the employer 3/. Remunerating the employee by providing him with a holiday trip is no less an expense of generating business income than paying the employee's salary. Disallowance of the expense to the employer would be both inequitable and, under some circumstances, ineffectual. If the employer were a tax-exempt organization such as a charitable institution, disallowance of an employment expense that conferred a benefit on employees would be meaningless and the employees of tax-exempt institutions could enjoy an advantage compared with other employees.

To include all of the employee's travelling, living and entertainment expenses paid for by the employer in the income of the employee without any deductions to the employee would usually result in over-taxation of the employee. At the other extreme, to exclude all of these employer-paid expenses from the income of the employee, or to allow the employee to deduct all

expenses under all circumstances, would open a wide avenue for tax avoidance. Some middle ground must be found.

This problem of separating the element of personal benefit is difficult enough, but there is a complication that cannot be ignored. It is not unusual for several employees to enjoy simultaneously the same facility provided by an employer, and for employees to share the same facility with customers or clients. A company cafeteria providing free meals utilized both by employees and customers is not uncommon. Assuming that the market value of the meals provided by the employer is known, to whom and how is the benefit provided by the cafeteria to be allocated? Does the employer have to go to the trouble and expense of recording every meal taken by every employee? How could the company allocate part of the benefit to its guests? To allocate to the employees the benefits enjoyed by the guests would be quite unreasonable. To separate the element of personal benefit in employer-paid expenses, yet provide flexibility where the benefit cannot be readily allocated to specific employees, we recommend the following approach:

1. The Regulations should specify the upper limits for travelling and entertainment expenses that would be exempt where the travelling or entertainment had a bona fide business purpose. Where there was no business purpose, there would be no exemption.

2. The travelling and entertainment expenses of an employee in excess of these limits, if paid by the employer either directly or through reimbursing the employee, would be defined as a benefit and would be:
   a) added to the income of the employee, or
   b) subject to a tax levied on the employer.

3. Employers unable or unwilling to allocate a non-cash benefit to employees (or others) would be required to pay a special tax on the unallocated benefit. Thus, if the employer could not or would not allocate the value of the free meals in the cafeteria between employees and customers,

or to particular employees, the employer would be required to pay a special tax on the unallocated benefit.

The special tax on the employer would be designed to ensure that the cost to the employer would be the same whether the employer provided an employee with taxable income or a non-cash benefit that was not taxed to the employee. To illustrate what would be required, consider an employer who paid a taxable cash bonus of $200 to an employee who paid tax on this sum at the rate of 50 per cent. The employee could buy $100 worth of goods and services in the market from the bonus after tax. The tax on the employer must be such that if the employer gave the same employee a non-cash benefit with a market value of $100 that was not included in the income of the employee, the cost to the employer would also be $200. This could be achieved by taxing the employer at the top marginal personal rate on the before-tax income that an employee in the highest income bracket would have to receive in order to buy the benefit with after-tax income. The special tax paid by the employer on the non-cash benefit that was not taxed to the employee should be treated as an expense to the employer for tax purposes so that the cost to the employer would be exactly the same in both circumstances.

Deduction of Expenses

We now turn to consider the deduction of expenses by employees. The principle involved is clear enough. <u>All</u> of the expenses incurred in the expectation of generating net gains, other than personal living expenses, should be allowed as deductions from all actual gross gains. Distinctions between the kinds and forms of taxable gains, and considerations of whether a net gain actually resulted from the expenditures, are irrelevant. The major problem would be to allow the deduction of all expenses laid out to generate employment income and yet to prevent the deduction of personal living expenses. In most cases it would be obvious that a particular expense fell on one side of the line or the other, but one area of uncertainty would not be dealt with readily.

In our view the deduction of expenses by employees and self-employed persons should be treated in exactly the same way. The present unfair discrimination against employees should be removed. However, because a large number of employees would be involved, the task of assessment would be enormous if each employee submitted an itemized claim for his or her actual expenses. To reduce the administrative problem to manageable proportions we think it would be necessary to provide an optional deduction of a percentage of gross employment income, with a dollar limit, that could be taken by an employee in lieu of the deduction of actual expenses. Those employees with deductible expenses greater than the percentage deduction should be able to deduct their actual expenses. Because self-employed individuals would be expected to have expenses in excess of the optional deduction proposed, we do not feel that this proposal discriminates in favour of employees.

For greater certainty, and to ensure that some obvious personal living expenses would not be deducted, the Regulations should specify those expenses that could not be deducted from gross income by employees, or any other individual, under any circumstances. Such things as commuting expenses, the costs of child care, and recreational club memberships should be explicitly denied as deductions from income.

We now turn to a brief description of the present treatment of employment income in Canada, the United States and the United Kingdom.

THE PRESENT SYSTEM: CANADA

The word "employment" is defined in section 139(1)(m) of the Canadian Income Tax Act as "the position of an individual in the service of some other person (including Her Majesty or a foreign state or sovereign)". It is also provided in section 139(1)(1a) that "employee" includes "officer", and in section 139(1)(ab) that "office" is the position of an individual entitling him to a fixed or ascertainable stipend or remuneration, and includes a

judicial office, the offices of a Minister of the Crown, and a member of the Senate or the House of Commons or of a provincial legislature. An office also includes the position of corporation director.

It follows that three types of persons are or may be classed as employees under the Act: persons who are employees in the usually understood sense, being in receipt of salaries and wages; officers, as defined, who receive payment for the offices they hold rather than for the specific work they do; and commission salesmen who are under contract to provide services to an employer.

If the same tax treatment were to be applied under our proposals to all kinds of income, it would be unnecessary to define employment or income from employment. However, because we propose to allow an optional percentage deduction with respect to income from employment in lieu of actual expenses, and because some other exemptions are related to employment income, for example, employment income of dependent children, a definition would have to remain in the Act, although the significance of the definition would be greatly reduced. The present definition appears to be adequate for this purpose.

Treatment of Benefits

Income from an office or employment is brought into charge, together with income from all other sources, under section 3 of the Income Tax Act. The components of employment income are then set out in detail in section 5 of the Act, and include not only wages and salaries and other remuneration, including gratuities, but also the value of "board, lodging and other benefits of any kind whatsoever....received or enjoyed...in the year", but with certain exemptions such as an employer's contributions to a pension plan and certain other employee benefit plans. All amounts received by an employee "as an allowance for personal or living expenses or as an allowance for any other purpose", again with certain exceptions, are also included in

his income. Allowances for board and lodging and travel expenses paid to construction workers in specified circumstances are excluded from their income. Special provisions cover allowances paid to certain other types of employees for travelling expenses.

In addition to section 5, there are other provisions of the Act which specifically bring into tax amounts related to employment, even though some of these would appear to fall within section 5. Section 6 brings into tax directors' or other fees and retiring allowances. The latter include amounts received in respect of loss of office as well as on or after retirement in recognition of long service. Section 25 brings into tax various payments made by an employer to an employee which in substance are from an office or employment but which, save for that section, might escape the tax net.

Excluded from income under section 10 or the Act are various receipts such as unemployment insurance benefits, workmen's compensation benefits, service pensions and expense allowances paid to members of provincial legislatures and municipal officers. Expense allowances paid to Members of Parliament are excluded under the Senate and House of Commons Act 4/.

There is nothing in the Act that would suggest that any distinction is to be made between benefits that come into the pocket and those that save the pocket. Indeed, the use of the words benefits "enjoyed" as well as those "received" seems clearly to include benefits that save the pocket. The meaning of the phrase "benefits of any kind whatsoever" has received little consideration in the courts. However, the administration appears to interpret the expression narrowly, thereby excluding many benefits that should be taxed. Excluded by departmental practice in specified cases are: discounts on merchandise, transportation passes, subsidized meals, special clothing, subsidized school services, transportation to the job, interest-free loans, free recreational facilities, removal expenses and tuition fees. On the other hand, rent-free or low rent housing, personal use of the employer's car, gifts and prizes are taxed at regular rates 5/.

Some employee benefits such as stock options, retiring allowances and death benefits are accorded preferential treatment under the Act 6/.

There is no apparent logic in the uneven treatment of these employee benefits. Because all of the benefits are not available to all employees, inequities between employees are both common and, in some circumstances, substantial.

Deductions

The few deductions from income permitted in computing income from employment are specifically set out in the Act. Some of these apply only to special classes of employees, such as the value of, or rent paid for, a clergyman's residence, certain expenses of railway workers and transport employees, and expenses of employed commission salesmen. Others are general, such as contributions to a pension fund, professional or union dues, and legal expenses incurred in collecting salary or wages due. Some are allowable only if the employee is required by his contract of employment to incur them, such as office rent, salary paid to an assistant or substitute, and the cost of supplies consumed directly in the performance of the duties of the employment. The permissive provision for deduction of these severely limited expenses closes with the words "but without any other deductions whatsoever". Nevertheless, an employee, in common with all other taxpayers, is allowed other deductions in computing "income", as distinct from "employment income". Examples are alimony and tuition fees in certain circumstances.

THE PRESENT SYSTEM: THE UNITED KINGDOM

Treatment of Benefits

The treatment of employee benefits in the United Kingdom is not entirely consistent. The basic principle, established by the decision of the House of Lords in Tennant v. Smith, 7/ is that fringe benefits are not taxable unless they can be turned into money at the employee's option. For example,

free meals provided by an employer would not be taxable because they would be available for the employee's consumption only. However, this principle has not always been consistently observed by the courts. For example, the discharge by an employer of an employee's pecuniary obligation not incurred in the course of employment gives rise to a benefit which the employee may have no option to convert into money but which is treated as part of the employee's income. Also, the principle that benefits not convertible into money are not taxable, has been narrowed by the Finance Act, 1963, which provides that an employee who occupies premises by reason of his employment is taxable on the difference between the rent he pays and the market rent of the premises.

An attempt was made to prevent tax avoidance occasioned by the granting of fringe benefits and allowances in kind, through legislation directed toward the class of employees who were thought to enjoy substantial benefits which escaped taxation. It applied to company directors and others whose salaries plus payments and benefits in kind amounted to £2,000 a year or more. Such people were required to bring into income all benefits in kind received as remuneration whether or not they were convertible into money. However, business entertainment expenses are now to be dealt with in a different way. Abuse in the deduction of these expenses led to the enactment of provisions in the Finance Act, 1965, prohibiting the deduction of all such expenses except those incurred in entertaining overseas customers if the entertainment is of a kind and on a scale which is reasonable in the circumstances.

The Royal Commission on the Taxation of Profits and Income stated: "Theoretically, all benefits in kind received in the course of employment and attributable to it are a form of remuneration and should rank as taxable income, since otherwise one taxpayer's income is not equitably balanced against another's" 8/. But in spite of this acknowledgment of the need to bring benefits into income, the Commission decided that "in practice the burden of administration would be so great that we do not regard an extension of the present law as justified unless the absolute loss of tax and the

relative irregularities between different taxpayers are greater than we believe them to be.... It is not possible to obtain any figures that really bear on the point" 9/.

Deductions

The United Kingdom Income Tax Act is very restrictive in the deductibility of employees' expenses. What is known as the "Schedule E rule" under which all employment income is charged is still in the same form as when it was enacted over a century ago, and states that if the holder of an office or employment

> "...is necessarily obliged to incur and defray out of the emoluments thereof the expenses of travelling in the performance of the duties of the office or employment, or of keeping and maintaining a horse to enable him to perform the same, or otherwise to expend money wholly, exclusively and necessarily in the performance of the said duties, there may be deducted from the emoluments to be assessed the expenses so necessarily incurred and defrayed."

When this rule was enacted, the only people assessed under Schedule E were the holders of certain public offices, such as Members of Parliament, all other employees being taxed under Schedule D. But in 1922 the vast army of salary and wage earners subject to "Pay As You Earn" was transferred from Schedule D to Schedule E.

The severity with which the Schedule E rule has been interpreted has caused such a volume of strong words from judges that the Royal Commission was moved to remark that "there can have been no part of the income tax code which has been so regularly the subject of unfavourable notice" 10/. The narrowness of the Schedule E rule can be seen if it is compared with the rule for deduction of business expenses under Schedule D, which is that no expenses may be deducted except those "wholly and exclusively laid out or expended for the purposes of trade...." There is no requirement under this test that there be an obligation to incur the expenses, as in the Schedule E rule, and no requirement that the expense must have been "necessarily" incurred; and

whereas under the Schedule E rule the expense must have been incurred "in the performance of the duties", that is, in the actual earning of the income, business expenses need be incurred only "for the purposes of" the trade. Furthermore, even if the other requirements of the Schedule E rule are met, the expense will not be allowed unless it is incurred by the holder of the office or employment as such.

The United Kingdom Royal Commission worded its conclusion on the question of deductions from employment income as follows:

> "Finally, we came to the conclusion that the best solution was to recommend a rewording of Rule 9 (the Schedule E rule) on less restricted lines. The wording that we propose would allow the deduction of 'all expenses reasonably incurred for the appropriate performance of the duties of the office or employment'. We have chosen this wording in order to bring the wording of Rule 9 into a closer conformity with the wording of the Schedule D rule and to remove the genuine cause of complaint that the Legislature deliberately imposes upon those in employment a narrower form of allowance for expenses than it accords to those who are deriving a profit (income) from their own efforts." 11/

Withholding of Tax

The United Kingdom system of withholding tax at source from employment income is known as Pay As You Earn. The amount of tax deducted from each payment of wages keeps in step with the employee's income, so that the total tax borne at any date in the year is related to the total earnings to date. A unique feature of the system is that if there has been any over-withholding, the employer must make the necessary refund to the employee and adjust his account with the Revenue. The system appears to be administratively more expensive and complex than the present Canadian system, but has advantages as a built-in stabilizer for the economy.

THE PRESENT SYSTEM: THE UNITED STATES

Treatment of Benefits

The general treatment in the United States of employee benefits in kind is succinctly described as follows:

"The use of benefits in kind as wage and salary supplements has become increasingly widespread in recent years, and has created a major issue of tax policy. These so-called fringe benefits may include meals and lodging furnished to employees at no cost, free medical services, health and accident insurance, discounts on merchandise purchased from the employer, recreational facilities, free parking spaces, bargain lunches, and in some instances free training and other educational opportunities.

"As a practical matter, this type of non-cash compensation has to a large extent escaped taxation. Although the scope of section 61 would appear to be broad enough to include most or all of such items in the tax base, and although the Regulations expressly state that 'if services are paid for other than in money, the fair market value of the property ... taken in payment must be included in income' ... the Internal Revenue Service has thus far made no full-scale effort to tax the value of fringe benefits to the employee-recipients." 12/

In Canada an employee may be taxed in respect of an allowance from which he derives no personal benefit but which he uses to meet certain business expenses for which he can claim no deduction 13/. However, the general rule in the United States appears to be that an employee is taxable only to the extent that he benefits personally from an allowance or reimbursement paid to him by his employer. While an employee is required to include an allowance or reimbursement in his gross income, he is entitled to deduct his operating expenses as an employee, since his employment is regarded as a trade or business.

Deductions

The treatment of an employee's expenses in the United States is quite different from that in Canada and the United Kingdom, and far more rational. There is some difference in the treatment of these expenses and the treatment of business expenses, but this seems to be more a matter of practice than of principle.

The main point of departure from the Canadian concept is that an employee is considered to be carrying on a trade or business and is entitled under section 162 of the Internal Revenue Code to the same "ordinary and necessary" business expenses as the self-employed business or professional man. The difference between the treatment of the expenses of a businessman and of an

employee is simply that the former may deduct all ordinary and necessary expenses and take the standard deduction 14/ as well, while an employee who wishes to take the standard deduction may claim only expenses falling within four specified categories: reimbursed expenses, travel expenses away from home; transportation expenses; and expenses of outside salesmen. However, other ordinary and necessary expenses may be deducted in lieu of the standard deduction. Reporting requirements are detailed and stringent.

Clearly the United States has gone a long way toward recognizing that businessmen and employees should be treated on the same basis in the matter of deductible expenses, in that employees are entitled to deduct ordinary and necessary expenses incurred in connection with their employment.

THE PROPOSED TREATMENT OF THE GROSS GAINS FROM EMPLOYMENT

We recommend that the Income Tax Act should include a general charging section that would bring into the personal tax base all receipts, gains and benefits. This would obviously cover wages, salaries, other forms of cash remuneration, including gratuities, and all non-cash benefits provided by an employer. For greater certainty, the Regulations should also specify certain expenditures, or revenues forgone, by employers that would be deemed to provide taxable benefits to employees (or others). Included in the specified expenditures should be amounts deducted by an employer in the computation of his income and set aside for future payment to the employee, rather than being paid to him in the year. The Regulations should then provide for the following alternative tax treatment of these benefits:

1. The value of these deemed benefits should be reported by the employer to the beneficiary and included in the tax base of the employee or other person who had received or had an opportunity to receive them, failing which,

2. The employer should be required to pay a special tax equal to the tax that would have been paid by an individual in the highest income tax

bracket on the before-tax income necessary to buy the benefit in the market with tax-paid income. The special tax would itself be deductible in computing the employer's income 15/.

The second alternative would be available to employers who were unable or unwilling to allocate benefits in kind to employees (and others). Under this alternative there would be no tax advantage to an employer or employee in remunerating an employee in non-cash benefits that were not taxed to the employee. For all employees except those in the highest income tax bracket, where there would be neither tax advantage nor disadvantage, the cost to the employer of providing a given after-tax benefit to the employee would be less if the benefit was reported as income of the employee than if the employer paid the special tax on it. Assuming the same total cost to the employer, the employee would benefit more from a cash payment than from a benefit in kind which is not reported as his income.

While the administration would have to be vigilant to ensure that all benefits provided by employers were subjected to one or the other of these tax treatments, the administration would not have to be concerned about the alternative selected by the employer. To keep costs down, employers would be most reluctant to provide non-cash benefits that could not be allocated to their employees.

Once the tax advantage derived from providing tax-free benefits to employees had been removed, we would expect that employers and their employees would be less interested in fringe benefits and more interested in cash remuneration. The present treatment encourages a substitution of tax-free fringe benefits for taxable benefits. Under our approach neutrality between the forms of remuneration would be restored.

Lump Sum Receipts

We now discuss the specific treatment we recommend for some of the more important forms of employment income. But before doing so we wish to point

out that the lump sum receipts of employees that would be brought into income under our approach would not require special alleviating provisions. We believe the proposed averaging provisions of general application, explained in Chapter 13, would be adequate. Among the lump sum receipts of employees that could be brought into income without special alleviation are: payments on loss of office, retiring allowances, death benefits, cash bonuses, current distributions from profit sharing plans, and stock option benefits.

Stock Options

The value of stock options for tax purposes should be defined as the difference between the option price of the shares to the employee and the market price at the time the option is exercised by him and this should be included in the employee's income 16/. The cost basis of the shares to the employee would then be the market price at the time they are acquired. Special rules will be necessary to deal with cases where stock options are assigned before they are exercised. The cost of an option is not imposed on a company but is borne by shareholders in a dilution in the value of their shares. Shares sold outright to employees below market price should be similarly treated in principle, but where the discount was small and the shares were available to all employees this benefit could probably be ignored, particularly because the value of the benefit would be picked up in the taxation of share gains.

Non-Accountable Allowances

All allowances that are at present non-taxable, such as those paid to Members of Parliament and provincial legislative bodies and to municipal officers, should be included in income in the ordinary way. Actual expenses, unless explicitly denied, would be deductible. The riding of an elected representative should be deemed to be his home, so that his actual living expenses while attending sessions of the legislature would be deductible, within limits to be specified, as travelling expenses. The only allowances

we would exclude from tax are those paid to direct representatives of the Crown, namely, the Governor General and the Lieutenant-Governors.

Deferred Compensation

Deferred compensation payments, other than those provided for under registered pension plans, should be included in the income of the employee when such amounts are paid into a trust fund or to an insurer by the employer for the benefit of the employee. This would mean that the income of the employee and the deduction for the employer would occur at the same time.

We recommend that amounts deducted by an employer in his computation of income, but not immediately paid to the employee, should be deemed to be an employee benefit. This provision should encompass the many kinds of arrangements that are entered into to postpone the time when an employee will have to bring an amount into income. However, the legislation should specifically exclude from the application of this provision amounts that are paid to the employee in the subsequent year.

Retirement Income Plans

We recommend in Chapter 16 that retirement income plans, including all types of plans that provide retirement income for the beneficiary, such as pension plans, profit sharing plans and retirement savings plans, should be either registered or non-registered plans. However, only one set of requirements would be applicable for Registered Retirement Income Plans, instead of the varying treatment that now applies to different kinds of plans. Contributions to registered plans would be deductible from current income, within limits, and the proceeds taxed in the hands of individuals when paid out. Contributions to non-registered plans would not be deductible in computing income.

There can be no doubt that the contributions of employers to employee pension plans constitute benefits to employees. However, there would be no

point in requiring employees to include in income employer contributions to registered plans because these contributions would be deductible by the employees in any event. Because the limits on the registered plans relate to what can be withdrawn rather than what can be put in, and because the limits would be enforced by the trustees of such plans nothing would be gained by adding employers' contributions to registered plans to the income of employees. However, employer contributions to a non-registered plan should be added to the income of the employee when the contributions were made, or should be subject to the special tax on unallocated benefits.

Insurance Premiums

Three kinds of insurance for employees can be distinguished:

1. Life insurance.
2. Hospital and medical insurance.
3. All other insurance, including unemployment insurance, workmen's compensation, supplementary unemployment insurance and group sickness and accident insurance.

Further discussion of 1 and 3 is contained in Chapters 16 and 18. Our recommendations are summarized below.

<u>Life Insurance</u>. Although our general recommendation is that initially life insurance premiums should not be deductible and that the proceeds on death or maturity should be excluded from income (although the investment income would be taxable), in the case of group life insurance we recommend that premiums should be deductible and that any benefits should be included in full in income. Thus, we propose that group insurance should be taxed in the same way as that recommended below for the various kinds of income insurance plans. This approach would simplify the administration of employee benefit plans because it would not be necessary for the employer to include in the income of the employee, premiums paid under group insurance plans. Employee contributions should also be deductible.

Hospital and Medical Insurance. Hospital insurance premiums paid by an employer should be included in the incomes of employees or should be subject to the tax on unallocated benefits, to provide a consistent treatment of taxpayers across Canada. Some provinces require individuals to pay premiums to finance hospital schemes, while others finance these schemes through a general sales tax. As we have indicated in Chapter 12, we cannot recommend that individuals and families be allowed to deduct hospital premiums because this would put taxpayers in provinces that finance hospital schemes from sales taxes at a disadvantage; they would have no identifiable amount to deduct. On the other hand, not to add the premiums paid by employers to the income of employees would be unfair to employees who had to pay them out of taxed income.

Only medical expenses, including medical insurance premiums, in excess of 3 per cent of income would be allowed as a deduction to a taxpayer. Therefore, in order to make the 3 per cent floor equally effective for all taxpayers, it would be necessary to include in employees' incomes the medical insurance premiums paid by their employers.

Other Insurance. When the proceeds from an insurance policy are taxable, the premiums should be deductible. Because we propose to tax the proceeds from insurance policies that maintain the income of the individual in the event of unemployment, illness and disability, premiums on such policies should be deductible to the employee, whether or not the employee claims the optional 3 per cent deduction referred to later in this chapter. There would be no point in requiring employers who paid the premiums on these kinds of policies on behalf of their employees, to add these premiums to the employees' incomes, because they would be deductible by the employees in any event. Therefore, we recommend that employer contributions to unemployment insurance and workmen's compensation, and premiums paid by employers on behalf of their employees for supplementary unemployment insurance and group disability insurance, that is, salary continuance insurance, should not be included in the incomes of employees nor taxed to the employer if unallocated to employees.

Free, Subsidized or Discounted
Goods and Services

When an employee is supplied by an employer with free goods and services, is allowed to buy goods and services subsidized by the employer or is allowed to buy the stock-in-trade of the employer at discount prices, a benefit should be deemed to have been conferred on the employee. The employee should be required to bring into income the difference between the value of the goods or services obtained from the employer and the cost to the employee 17/. If the employer is unable or unwilling to allocate these benefits to employees, the employer should be required to pay the special tax on unallocated benefits.

Among goods and services provided to employees (or others) by employers that should be subjected to this treatment the following may be noted:

1. Meals.

2. Housing.

3. Direct costs of schooling for the children of employees.

4. Loans.

5. Transportation passes.

6. Recreational facilities, including summer cottages, lodges, fishing and hunting camps, yachts, and golf courses.

Fees and Dues

All club, union or association fees or dues paid by an employer for an employee should be included in the income of the employee 18/. Expenses incurred by an employee in entertaining at a club for business purposes would be treated in the same way as entertainment expenses generally, as described below.

Costs Incurred by or on Behalf of an
Employee When Away from Home on Business

We recommend that the following expenses incurred by or for an employee while away from home on a bona fide business trip, and paid by the employer, should not be added to the employee's income for tax purposes:

1. Actual transportation expenses.
2. Actual expenses for meals and lodging within specified limits.
3. Expenses as aforesaid of attending a specified number of conferences a year, with a specified limit for registration fees.

The Regulations should specify the limits under 2 and 3. The limits might vary with the salary of the employee, to reflect the cost of obtaining comparable accommodation, and perhaps should take into account the size of the city or town visited by the employee, to reflect the fact that living expenses are usually higher in metropolitan areas than in small towns. The limit under 2 should not exceed $25 a day at current prices. Two conferences a year, with a maximum registration fee of $35 to $50 for each conference, probably would be sensible limits under 3. 19/ However, we state these limits only to give an indication of our thinking. We would suggest that the detailed limits should be determined after a careful review of living costs and in consultation with the informal advisory committee of non-governmental experts that we recommend in Chapter 32 should be established to aid the Department of Finance.

Expenses incurred by an employer on behalf of an employee in excess of the specified limits would be added to the income of the employee or taxed to the employer in the manner we have described. For pleasure trips the limits would, of course, be zero. All of the expense would be taxed to the employee or the employer. When the trip was partly for business and partly for pleasure, the transportation expenses would be apportioned.

The limits would apply to actual expenses. All expenses would have to

be supported by expense vouchers or other documents.

Entertainment Expenses

Where an employer reimbursed an employee for his bona fide business entertainment expenses, or paid bona fide business entertainment bills incurred by the employee, we recommend that actual expenses over limits specified in the Regulations should be added to the income of the employee or taxed to the employer in the prescribed manner. An upper limit of $5 to $10 per person entertained per day probably would be suitable at current prices, but here again we suggest consultation with the informal advisory committee. The limit on entertainment expenses that did not have a reasonable business purpose would, of course, be zero. The employer would be required to keep detailed records of who was entertained, where, at what cost, and why. Only actual expenses would be allowed and all expenses would have to be supported by expense accounts or other documents.

If experience showed that this procedure was being abused or was unenforceable, we recommend that all entertainment expenses be added to the income of the employee or taxed to the employer in the prescribed manner. This procedure would be similar to that in the United Kingdom where these expenses are disallowed.

We suggest arbitrary limits with respect to travelling and entertainment expense because we consider that assessors should not be required to judge what amounts are appropriate in each circumstance.

Automobiles and Aircraft

The value of the personal use by an employee of his employer's car or aircraft should be brought into the income of the employee or taxed to the employer in the prescribed manner. In the case of an aircraft a detailed log should be kept, showing for each trip the names of passengers carried, the points of departure and destination and the purpose of the trip. Unless

the log supported the claim that the trip had a business purpose, personal use should be assumed.

Miscellaneous

Fees paid by an employer for an educational course taken by an employee should be included in the employee's income; the employee should then be allowed to deduct the amounts specified in the general provisions for post-secondary educational expense discussed in Chapter 12. If not added to the income of the employee, the expense should be taxed to the employer in the manner we have described. The same treatment should apply to scholarships, fellowships, bursaries and awards to employees.

Strike pay should be included in the incomes of union members when received, or the union should pay the special tax in the manner described above. Since strike pay is a form of benefit under an informal income maintenance insurance scheme, there is no doubt that it is income to the recipient. This would not involve "double taxation" because union dues would be deductible to the members.

Exclusions

We recommend that the following items provided by employers be statutorily excluded from the employee's income, either because the amounts involved are too trifling to make it administratively worth while to include them, or because they cannot be said to confer a true benefit: employer subsidies to community schools; special clothing provided by employers; removal expenses paid by the employer where necessitated by the job; and tools and equipment for use in day-to-day work provided by an employer.

Summary

In our recommendations concerning employee benefits we have tried to treat all kinds of benefits obtained by all kinds of employees on the same basis. If our proposals were adopted, we think they would substantially

reduce the abuses of "expense account living". The tax revenues lost through expense account living may be relatively small, but to the few individuals involved it provides an advantage that is as important as it is unwarranted. These abuses should not be allowed to continue. The self-assessment system of taxation is only a viable system if taxpayers believe that everyone is bearing his fair share of the tax burden. This attitude can only prevail when all personal consumption expenditures are made from tax-paid income. We have tried to design a method of taxing non-cash benefits that would be both stringent and enforceable. The arbitrary features of the system we propose would be inevitable if the provisions were to be effectively and consistently enforced. It would be necessary for the tax authorities to continue to review expenditures that were not allocated to employees or taxed on the special basis. Possibly some detailed reporting of these expenditures would be required of employers in respect of amounts claimed to fall within the established limits.

Because all employees of all competing organizations would be subject to the same rigorous rules, we do not believe that the apparent harshness of the provisions we recommend would have a detrimental impact on business.

PROPOSED TREATMENT OF DEDUCTIONS IN COMPUTING EMPLOYMENT INCOME

The restrictive nature of the law on the question of employees' deductions has already been noted in our summary of the present Canadian system. In order to understand the present position and the problems arising out of it, it is necessary to trace briefly the history of the treatment of these expenses.

The Income War Tax Act defined income, in part, as "the annual net profit or gain", and allowed deductions from gross income of amounts "wholly, exclusively and necessarily" incurred in earning it. In theory, therefore, employment income was dealt with on the same basis as business income, and this concept was confirmed by the courts 20/. However, practice was quite

different from theory, and the words "wholly, exclusively and necessarily" were so stringently interpreted where employees were concerned as to result in the assessment of employment income virtually on the gross amounts received 21/.

In 1948, following the Bond case, 20/ a change was made in the law which gave with one hand while taking away with the other. Two minor concessions were made with regard to certain travelling expenses, but it was specifically stated that in computing employment income "no amount is deductible for a disbursement or expense laid out for the purpose of earning the income", a provision in direct contrast to the declared treatment of business expenses.

Until the two concessions were made in 1948, the only deduction allowed by statute in computing employment income was a contribution to a pension or superannuation fund. Since 1948 a few more concessions have been made, but the resulting hodge-podge does not change the basic principle that employment income for tax purposes is gross income; the few specified deductions emphasize rather than change that principle.

The treatment of employment income must be compared with that given to business income, which includes income from a profession. The Act specifically states that income from a business is the "profit" therefrom for the year, and in effect allows the deduction of all reasonable expenses incurred "for the purpose of gaining or producing income", without any specific mention of what may be deducted. The basic principle is therefore quite different from that underlying the treatment of employment income.

The inequity of the law in general, as applied to employees, has shown up strongly in the few appeals taken by employees to the Tax Appeal Board. The small number of such appeals is not a measure of the discontent felt with the legislation but rather an indication of its efficiency; any appeal for deduction of an expense not specifically allowed, even where it is admitted by everyone that it was incurred for the purpose of earning the income, is

doomed from the start. One public-spirited taxpayer, a journalist, took to the Board an appeal which he stated he knew he had no chance of winning, but which he hoped might help to draw the attention of the authorities to the plight of people who had to incur certain expenses in earning their salaries but for whom no relief was available. He himself was both salaried and free-lance, and the lack of logic in the law's treatment of his expenses was emphasized by the fact that he was allowed to deduct in his capacity as free-lance the selfsame expenses he was prohibited from deducting from his salary. The same situation prevailed in another case, involving a member of the Toronto Symphony Orchestra 22/.

For many employees this stringent treatment may cause little or no hardship but, regardless of the number of taxpayers involved, the legislation is unfair and should be changed.

The main problems in removing this discrimination are administrative. First, there is the question of distinguishing the personal and business elements in many of these expenses, such as those on travel, entertainment, attending conventions, and so on. But this problem exists just as much in the area of business income. Second, there is the problem of numbers. There are about nine times as many employed taxpayers in Canada as there are self-employed taxpayers, or over 4.5 million employees to about 0.5 million self-employed 23/. The Department of National Revenue admits that it has difficulty checking the expense claims of even 0.5 million; it would find it quite impossible to handle expense claims for all employees as well without an enormous increase in staff.

Possible Alternatives

We considered a number of alternatives as possible remedies for the present unsatisfactory situation.

One was to maintain the present general system of permitting only

specified deductions, but to give additional deductions to employees. Although such an approach would relieve some of the inequities, it would still not be in accord with the general principle that it is net income that should be taxed and that therefore all costs related to the earning of income should be deductible. It would also still be discriminatory as between employees and others.

We also considered the possibility of adopting the "earned income allowance" which is part of the United Kingdom structure. There it is applied not only to employment income but to all earned income. It is a fixed percentage of that income and is allowed regardless of the amounts actually spent. If this provision were applied to all earned income in Canada, it would merely perpetuate the discrimination between employees and others; and if it were applied to employment income only, it would seem to contravene the original justification for its being granted in the United Kingdom, which was that earned income was more "precarious" than other income. There seems to be no more precariousness attached to employment income than to other types of income. In fact, one of the basic principles underlying our recommendations is that all income increases the economic power of the recipient in the same way, regardless of the kind or source, and therefore all income should be taxed in the same manner.

Another alternative would be to change the basic wording of the present rules regarding employees' deductions, and to adopt a rule something like that suggested by the United Kingdom Royal Commission on the Taxation of Profits and Income, that is, to allow deduction of "all expenses reasonably incurred for the appropriate performance of the duties of the office or employment". Such a rule would certainly permit more liberal allowances than the present system, but would still retain the inherent difference between employment and other income. Furthermore, it would not solve the administrative problem of reaching conclusions of fact in a very large number of cases.

Proposed Rules for Deductibility

We came to the conclusion that the most equitable course would be to treat employment income on the same basis as income from a business or profession. Expenses would then be deductible if reasonably related to the earning of income. The prohibition against the deduction of personal and living expenses as set out in section 12(1)(h) of the Income Tax Act would, of course, be applicable, as would the provision in section 12(2) that expenses must be reasonable in the circumstances.

The adoption of such a course would remove the unfair discrimination between the two kinds of income and should not lead to much additional litigation. As we have already stated, the United States does place employment income on the same basis as business income, and all "ordinary and necessary" expenses are deductible for both kinds of income.

However, because of the great numbers of taxpayers in receipt of employment income in Canada, and to obviate the need for processing numerous claims for relatively small items, we recommend an optional deduction of 3 per cent of gross employment income, up to a maximum deduction of $500. Any employee whose deductible expenses exceeded this figure would be at liberty to claim them in lieu of the optional 3 per cent deduction, provided they were itemized and substantiated. The deductibility of particular itemized expenses would then be determined in accordance with the rules to be applied to business expenses. Employees, like the self-employed, would not be permitted to deduct travelling and entertainment expenses in excess of the limits discussed earlier in this chapter.

It might be argued that such a blanket deduction would provide a concession to employees that would not be available to the self-employed. However, it would be expected that most self-employed individuals would have expenses in excess of the 3 per cent limit and that therefore such an option would be of little significance to them.

Although we recommend that in general all expenses reasonably related to the earning of employment income should be deductible, we also recommend that certain expenditures should be deemed to be of a personal nature regardless of their relationship to the earning of income and hence not deductible. We have made this recommendation because there are certain expenditures that are virtually impossible to classify as being either of a personal nature or for the purpose of earning income. In addition, certain expenditures have come to be regarded as a means of conveying personal benefits to employees. Thus, because the administrative problems in separating the "legitimate" expense from the personal expenditure would be great, and because we have concluded that a substantial proportion of such expenditures are in fact of a personal nature, we recommend that items of this kind should be arbitrarily deemed to be personal benefits and not deductible. We have listed commuting expenses, fees or dues to social or recreational clubs, and the cost of social or recreational facilities, including the expenses of pleasure boats, as items that should initially be included in such a list. Similarly, we suggest that all entertainment and travelling expenses in excess of specified arbitrary limits should in effect be deemed to be personal expenditures. We appreciate that some will regard this treatment to be unnecessarily harsh. However, we have considered a number of alternatives and found this to be the only solution that would provide some equity while being administratively feasible. In fact, we consider that these arbitrary rules would have to be amended and extended as experience was gained in administering the general allowance that we suggest. Nevertheless, such a result would be more equitable than the alternative of disallowing all the expenses of individuals related to the earning of income except those specifically permitted by the legislation.

In recommending a deduction of 3 per cent of employment income up to a maximum deduction of $500, we intend to provide an option that would be chosen by the vast majority of employees and yet would not provide an inordinate

concession to any. Should it be found on the basis of experience that a very high proportion of employees were claiming actual expenses, the terms of the optional blanket deduction should be made more attractive. In order to avoid a misconception, it should perhaps be pointed out that the 3 per cent deduction is for expenses incurred in earning income, and is entirely separate from, and does not cover, deductions made from net income for such things as charitable contributions and medical expenses, which are dealt with in Chapter 12, or the tax credit for working mothers which is dealt with in Chapter 11. Unemployment insurance contributions of employees, and the premiums paid by employees on Registered Retirement Income Plans and other income maintenance insurance policies would also be deductible whether or not the 3 per cent optional deduction were taken.

While they are not a perfect solution, we are convinced that our recommendations for the deduction of expenses for the earning of employment income would be substantially more equitable than the present system and would be administratively feasible.

WITHHOLDING OF TAX

The problem in this area is relatively small but present methods could be improved.

There is room for abuse in the taxation of income from casual labour where regular employers are involved. There is no requirement for individual reporting of earnings under $250. This permits workers to move from job to job and, as long as their earnings are less than $250 at any one job, there is no reporting or deduction at the source.

We recommend that a flat rate of tax of 15 per cent should be withheld from wages paid for casual labour, up to a maximum wage or a maximum period of days, after which the regular procedure for reporting and withholding tax from salaries or wages should be applied. This would apply to any employer who employed casual labour in the course of earning income.

Another aspect of the present withholding system that causes concern is the over-withholding of tax. Under the present somewhat rough and ready system, excessive tax can be and frequently is deducted. This occurs, for example, when an employee in the course of the year becomes entitled to additional exemptions or has periods of unemployment or periods of lower than average earnings, and may affect both taxable persons and persons who are non-taxable because their earnings do not exceed their exemptions. For example, in 1964, of the 5.3 million taxable individuals, 3.1 million, or over 58 per cent, received refunds; and of the 1.4 million non-taxable individuals who filed returns, 0.9 million, or over 64 per cent, received refunds. Because over-withholding usually is not rectified until after the end of the year, the deductions at source may work hardship in some cases. Some relief is available under Regulations 102(5) and 106, but to obtain the relief involves ministerial approval and the Regulations are apparently rarely used, possibly because most employees are unaware of their existence.

We believe that a cumulative system of tax deduction, similar to the pay-as-you-earn system used in the United Kingdom, may be preferable to the present Canadian system of withholding. However, in view of the fact that very few complaints were made to us about over-withholding we do not feel that we can recommend the adoption of a new, complicated system, particularly because it would involve considerable extra compliance costs to employers. As the use of electronic equipment by employers and in tax administration becomes more general, the adoption of a more accurate withholding method should be seriously considered.

CONCLUSIONS AND RECOMMENDATIONS

1. The comprehensive tax base, like the present law, requires the taxation of all net gains in cash or in kind from the performance of personal services. One problem is to enforce the taxation of non-cash benefits from employment while allowing the deduction of reasonable non-personal expenses in a way that does not create impossible administrative problems.

2. Because the present law is not effectively enforced, some employees receive non-cash benefits from their employers that are not taxed. This provides a tax advantage not available to taxpayers generally.

3. Because of the stringent limitations in the present law, employees are unable to deduct many expenses that are deductible by the self-employed. Skilled manual workers and employed professionals in particular are unfairly treated relative to the self-employed.

4. Equity requires that both types of unfair discrimination be eliminated from the tax system by effectively bringing all significant non-cash benefits into tax and by putting the deduction of expenses on the same basis for employees and the self-employed.

5. Travelling expenses and entertainment expenses pose a particularly difficult problem. When an employer pays these expenses for an employee or reimburses an employee for travelling and entertainment expenses, there may be a substantial element of personal benefit to the employee. To ignore this benefit would be to create a gaping loophole; to treat all of these expenses as personal benefits would be to penalize employees, or their employers, who incur such expenses for legitimate business purposes.

6. Where there are facilities of employers that could yield a benefit to many employees and to non-employees simultaneously, this compounds the problem because it is difficult to allocate the benefit.

7. Disallowing the travelling and entertaining expenses of employees would be inappropriate and in some cases ineffective: inappropriate because paying an employee by providing a non-cash benefit is just as much a cost of doing business as paying wages or salaries; ineffective because disallowance would not impose a restraint on tax-exempt employers.

8. An attempt to meet the problem only through the inclusion of some general rules in the law would, we believe, be doomed to failure. There are too many transactions and too many fine judgments required for effective enforcement of general rules. We believe there is no workable alternative to having some detailed and specific rules that give rough but effective justice.

GROSS GAINS

9. The Act should include a general charging provision that would bring all receipts, gains and benefits into the tax base of the individual or family. This would bring into tax all forms of employment income, including wages, salaries, bonuses and gratuities. For greater certainty, the Regulations should also specify certain expenditures, or revenues forgone by employers, that would be deemed to provide a benefit to employees (or others).

10. The value of these deemed benefits should be reported by the employer to the employees (or others), and included in their incomes, or the employer should be required to pay a special tax on them.

11. The special tax on the employer would apply when the employer was unable or unwilling to allocate benefits to individuals. The tax would be imposed at the top personal rate on the before-tax income that an individual paying tax at that rate would have to receive in order to buy the benefit in the market with after-tax income. The special tax would itself be deductible in computing the employer's income. There would therefore be no tax saving, and possibly an increase in the tax cost, if the employer provided non-cash benefits that were not taxed to the employee (or others).

RELIEVING PROVISIONS FOR
LUMP SUM BENEFITS

12. Because we recommend liberal averaging provisions of general application, no special relieving provisions would be necessary for lump sum receipts such as payments for loss of office, retiring allowances, death benefits, bonuses, distributions from profit sharing plans and stock option benefits.

STOCK OPTION BENEFITS

13. A stock option benefit should be taxable in full when the stock is acquired by the employee.

NON-ACCOUNTABLE ALLOWANCES

14. Allowances which are now tax free should be brought into income in the regular way. This should apply to allowances paid to members of the federal and provincial legislatures and to municipal officers.

RETIREMENT INCOME

15. Employer contributions to the Registered Retirement Income Plans of employees need not be brought into the incomes of the employees because these contributions would be deductible by them, together with the employees' own contributions, in any event. However, employer contributions to non-registered pension plans should be brought into the incomes of the employees.

INSURANCE PREMIUMS

16. Hospital insurance and medical insurance premiums paid by employers on behalf of employees should be brought into the income of the employees or taxed to the employer in the prescribed manner. This would be necessary because these premiums would be either not deductible, or would only be deductible by the employee under some

circumstances. Premiums on group life insurance policies and on policies of the income maintenance type, where the benefits would be taxable when received by the employee, should be deductible by the employee if paid by him. Thus, there would be no point in requiring the employer to add them to the income of the employee.

FREE, SUBSIDIZED OR DISCOUNTED
GOODS AND SERVICES

17. Free, subsidized or discounted goods and services provided to employees should be taxable as benefits to them or subject to the special tax on the employer as described above. When the good or service is of a kind sold by the employer, the value of the benefit should be based on the market value of the good or service. In all other cases, the value of the benefit should be the full cost to the employer. Among the more obvious goods and services provided by employers that should be treated in this way are: meals, housing, schools for children of employees, loans, transportation passes and recreational facilities including summer cottages, lodges, fishing and hunting camps, yachts and golf courses.

FEES AND DUES

18. All club, union and association fees or dues paid by an employer for an employee should be included in the income of the employee or taxed to the employer in the prescribed manner. Union and association fees or dues would normally be deductible by the employee, however, if he did not claim the optional 3 per cent deduction referred to below.

TRAVELLING AND ENTERTAINMENT EXPENSES

19. Travelling and entertainment expenses paid by an employer in excess of stipulated limits should be included in the income of the employee or taxed to the employer in the prescribed manner. Some limits are suggested in the chapter to give an indication of the orders of magnitude

we have in mind. We recommend that the limits be established after consultation with the informal advisory committee discussed in Chapter 32.

20. If experience showed that the provisions for entertainment expenses we recommend were being abused, then all entertainment expenses paid by an employer should be included in the income of the employee or taxed to the employer.

MISCELLANEOUS

21. The following benefits should be taxed to the employee or taxed to the employer in the prescribed manner:

a) The value of the personal use by an employee of his employer's automobile or aircraft.

b) Fees for educational courses paid by an employer.

c) Scholarships, fellowships, bursaries and awards to employees.

22. Strike pay should be included in the income of the union member or taxed to the union in the prescribed manner.

DEDUCTIONS

23. The same rules with respect to deductibility of expenses should apply to employees and to the self-employed. Expenses reasonably related to the earning of income should be deductible. There should be a general prohibition against the deduction of personal living expenses. For greater certainty, deductibility should be explicitly denied to such expenses as commuting expenses, fees or dues for social or recreational clubs and expenses related to the use of recreational facilities or pleasure boats. Also, travelling and entertainment costs in excess of the designated limits should be deemed to be personal expenditures.

24. To reduce the administrative burden, there should be an optional deduction of 3 per cent of employment income up to a maximum deduction of $500. This could be taken in lieu of the deduction of actual expenses.

WITHHOLDING OF TAX

25. As data handling and storage techniques improve and more employers become equipped to handle more elaborate tax withholding procedures, the present system should be refined. The pay-as-you-earn procedure now in effect in the United Kingdom may be preferable to the rough and ready Canadian system.

26. Regular employers should be required to withhold tax at a rate of 15 per cent on casual labour hired in the course of earning the employer's income.

REFERENCES

1/ See Gwyneth McGregor, Employees Deductions under the Income Tax, Canadian Tax Paper No. 21, Toronto: Canadian Tax Foundation, 1960.

2/ An employee may be required to pay travelling and entertainment expenses out of his salary or commission. The problem then is to ascertain the appropriate deduction from gross income. This side of the coin is dealt with later in this chapter. Obviously the personal benefit element in a living expense paid for by an employer that should be added to the income of the employee is the same element that should not be deducted by the employee who has met the expense out of wages, salary or commission.

3/ Disallowance would be appropriate, however, if the benefit provided was a gift from the employer to the employee.

4/ R.S.C. 1952, Chapter 249.

5/ See Department of National Revenue, Information Bulletins, Numbers 24 and 25, of February 15, 1964 and June 13, 1964, respectively.

6/ For an outline of this preferential treatment see Chapter 13.

7/ [1892] A.C. 150. For a detailed description of the United Kingdom treatment, see D.J. Sherbaniuk, Specific Types of Personal Income, a study published by the Commission.

8/ Royal Commission on the Taxation of Profits and Income, Final Report, Cmd. 9474, London: H.M.S.O., 1955, paragraph 211.

9/ Ibid., para. 215.

10/ Ibid., para. 129.

11/ Ibid., para. 140.

12/ Harvard Law School, International Program in Taxation, Taxation in the United States, World Tax Series, Boston: Little, Brown and Company, 1963, p. 538.

13/ For example, automobile allowances received by a public health nurse and by a hospital nurse for the use of their cars in transporting patients, were held to be part of their employment income, in Hawkins v. M.N.R., 50 DTC 472, and Campbell v. M.N.R., 55 DTC 434, respectively. A yearly travelling allowance paid to a county assessor was likewise held to be income from employment in Quance v. M.N.R., 52 DTC 237. An entertainment allowance paid to an insurance agent to be used when seeking insurance contracts was held part of his remuneration in Mr. S. v. M.N.R., 50 DTC 390.

14/ The lesser of $1,000 or 10 per cent of "adjusted gross income" (gross income less allowable expenses).

15/ Assume that the top personal rate of personal income tax is 50 per cent and the non-cash benefit has a market value of $100. In order to purchase from tax-paid income a benefit with a market value of $100, the employee would have to receive $200 from his employer and pay $100 in personal income tax. If the benefit were not brought into the employee's income, our proposal would require the employer to pay a special tax of $100 (50 per cent of $200). The employer's deductible expense would be $200 ($100 cost of the benefit plus $100 special tax), the same as it would have been if the employer had paid additional salary or a bonus of $200.

To be more precise, the employer would pay a special tax equal to $\frac{R \times B}{(100-R)}$, where R is the top marginal rate expressed as a percentage, and B is the cost of the benefit.

16/ Stock options are now dealt with in section 85A of the Income Tax Act.

17/ Where goods and services are of a kind sold by the employer, their market value should be used in valuing the benefit. For all other goods and services the full cost to the employer should be used for valuation purposes.

18/ Fees or dues to social or recreational clubs would not be deductible by the employee. However, employees should be able to deduct union dues or association fees (unless the optional percentage deduction is taken).

19/ It might also be reasonable to exclude conferences outside Canada unless they were sponsored by an international organization.

20/ Samson v. M.N.R., [1943] Ex. C.R. 17, and Bond v. M.N.R., [1946] Ex. C.R. 577.

21/ J.G. McDonald, Canadian Income Tax, Toronto: Butterworth, 1963, p. 171.

22/ Harbron v. M.N.R., 58 DTC 110; MacKay v. M.N.R., 58 DTC 447. A similar result was reached by the English courts in Mitchell and Edon v. Ross (1960) 40 T.C. 11.

23/ Information based on 1964 tax returns and supplied to us by the Department of National Revenue.

CHAPTER 15

PROPERTY INCOME

Rights to and interests in property can produce increases in economic power, whether held or disposed of. These increases take two basic forms: rents, dividends, royalties, interest, and other returns 1/ derived from holding property rights; and gains derived from increases in the market value of property rights.

The first form is already taxed as income in Canada, while the second is normally exempt as a "capital gain". While the changes we propose in the taxation of returns from holding property are minor, we suggest a major change in the tax treatment of gains on disposal of property.

We have emphasized in this Report that the only equitable basis for taxation is to include in the comprehensive tax base the value of all additions to economic power, including so-called capital gains. It may have been appropriate in years past to distinguish, for tax purposes, between gains flowing from property and those resulting from the acquisition and disposition of property, but in the current business and investment environment such a distinction has little if any significance. We are convinced that the failure to tax capital gains in Canada has no basis in principle; that it has led, and will continue to lead, to uncertainty as to which gains on the disposition of property are taxable and which are not; and that it affronts all the standards of equity and neutrality which we feel should characterize a tax system. In our view the exclusion of capital gains is no longer defensible, if it ever was. We are convinced that the time has come to abandon this exclusion and to replace it with a more logical, certain and equitable basis of taxation.

The inclusion in income of all gains from transactions in property is not without problems. In this chapter we describe the problems and suggest solutions. We consider whether and to what extent there should be allowances

for losses on such transactions; whether such gains and losses should be brought into income as they accrue or only when they are realized; whether and how these gains should be taxed when a taxpayer dies or ceases to be a resident of Canada; whether gains from property transactions should be taxed in the same way as other forms of gain, or whether they should receive preferential treatment; and how the receipt of lump sums from such transactions should be treated in order to avoid the application of unduly high marginal rates.

THE PRESENT POSITION

An extensive description and analysis of the Canadian treatment for tax purposes of gains on the disposition of property is given in three supporting studies, and the following discussion is therefore only a brief outline 2/. The basic approaches followed in the United Kingdom and in the United States have already been briefly discussed in Chapter 9.

The present position in Canada is that some receipts from the disposition of property are regarded as being of an income nature, and any gain arising therefrom is regarded as income subject to tax. Other such receipts are regarded as being of a capital nature, and the gain therefrom is regarded as an accretion to capital, or a capital gain, which is not subject to tax. None of the terms "income", "capital", or "capital gain" is defined in the legislation, and hence it is necessary to determine into which category a particular gain falls by having regard to the principles established in decisions of the courts.

The Distinction Between Income and Capital Gains—Business or Investment. The basic distinction drawn in the legal decisions is between a gain on the realization of an investment, which is capital, and a gain derived from the carrying on of a business, which is income 3/. In the Californian Copper Syndicate case, a leading United Kingdom decision on this branch of the law which has been followed in Canada, this distinction was expressed as follows:

"It is quite a well-settled principle in dealing with questions of assessment of Income Tax, that where the owner of an ordinary investment chooses to realize it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit...assessable to Income Tax. But it is equally well established that enhanced values obtained from realization or conversion of securities may be so assessable, where what is done is not merely a realization or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business. The simplest case is that of a person or association of persons buying and selling lands or securities speculatively, in order to make gain, dealing in such investments as a business, and thereby seeking to make profits. There are many companies which in their very inception are formed for such a purpose, and in these cases it is not doubtful that, where they make a gain by a realization, the gain they make is liable to be assessed for Income Tax.

"What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being—is the sum of gain that has been made a mere enhancement of value by realizing a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?" 4/

The Income Tax Act does not define "investment" but does contain a definition of "business". That term includes "a profession, calling, trade, manufacture or undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade". Ordinarily, where a business is carried on there would be a series of transactions of a particular kind. However, the inclusion of the words "adventure or concern in the nature of trade" in the definition in the Act has been interpreted by the courts to mean that an isolated transaction which has other characteristics of a business operation can also be treated as a business, and that any gain therefrom will be taxable.

In some cases, where the disposition of property results in a profit, there will be no real difficulty in determining whether that profit constitutes a capital gain or income. In recent years there have been a great many cases, however, in which the tax authorities have contended that a profit was taxable and a considerable amount of litigation has resulted. In cases of this kind, the courts, in deciding whether a particular gain arose from carrying on business or realizing an investment, consider the whole course of conduct of the taxpayer in connection with the matter,

including the circumstances in which the property was acquired, what was done with the property while it was held, and the circumstances in which the disposition took place. While they decide each case on its own facts, they have treated a number of factors as material in determining whether or not there was liability to tax.

Criteria of Business or Investment. One of the factors is the nature of the property involved in the case. If the property sold is itself productive of income, such as where a business is sold as a going concern, the transaction is probably the realization of an investment. If, on the other hand, an individual buys and resells articles which are ordinarily not held for investment but are bought and sold by commercial concerns, he may well have engaged in a scheme of a business nature.

Another factor to be considered is the frequency of transactions of a similar type in which the taxpayer has taken part. The more frequent such transactions are, the more likely it is that any profit will be regarded as income. Furthermore, the fact that a particular transaction is in a field related to the normal business of a taxpayer, or even in a business in which he was formerly engaged, would be an additional factor leading to a finding that it constitutes a business venture.

What the taxpayer has done with the property during his period of ownership will also be material. If, for example, land is purchased, an apartment building is built thereon, the apartments are leased over a period of years, and the building is then sold, the sale may constitute the realization of an investment. On the other hand, if the purchaser of land proceeds to sub-divide it and sells building lots, he may well be held to be carrying on the business of dealing in land and to be taxable on his gain.

The length of time an asset has been held may be significant. Ownership of an asset for a lengthy period is consistent with, but by no means conclusive, evidence of an investment. Ownership for a short time is more likely to be treated as pointing to a business operation.

A further and a very important factor is the intention the taxpayer had with regard to the property both at the time he acquired it and subsequently. The application of this very subjective test has not been entirely consistent and as a result has led to much of the uncertainty in the capital gains area. In particular, the attempts to ascertain a "secondary" or "alternative" intention of the taxpayer have increased the general uncertainty of taxpayers about the tax consequences of property transactions. At one extreme, an intention to retain indefinitely property that regularly produces income in the form of rents, interests or dividends would presumably indicate that the profit is of an investment nature. At the other extreme, the purchase of a perishable commodity with the expectation and intention of reselling it immediately at a profit would presumably mark the commencement of a trading operation. There can, however, be an infinite variety of cases falling between such extremes.

It often happens that the intention with which a particular property is acquired is not carried out. A taxpayer may, for a wide variety of reasons, change or abandon his original plan with regard to the property and take alternative action. He may also be prevented by circumstances beyond his control from carrying out his original intention. In such cases it is necessary for the courts, having regard to the altered circumstances, to determine whether a profit on disposition should be treated as capital or income. Added complexity has arisen in cases in which the courts have found that a taxpayer had primary and secondary intentions at the outset, and that if the primary intention was not or could not be carried out his course of action should be judged on the basis of his alternative or secondary intention.

The expectation of capital appreciation and ultimate sale at a profit and the absence of an immediate income return may not be inconsistent with investment. On the other hand, if organized activity of a business nature is devoted to a project, the resulting profit may be a business profit, but

the lack of such activity or any substantial amount of such activity need not rule out a scheme of profit making.

In any given case, the basic question for determination is whether the taxpayer's whole course of conduct is consistent with investment on the one hand or a scheme of profit making on the other. The application of readily stated principles to the facts of particular cases has often proved to be extremely difficult. The Canadian decisions in cases relating to alleged capital gains in recent years have more than borne out the observation in the Californian Copper Syndicate decision of 1904 that the line between investment and carrying on business is difficult to draw. Unfortunately these decisions and the reasons given therefor are not easily reconciled and seem far from consistent. The result is that doubt and uncertainty have existed for some years, and seem likely to continue, as to the circumstances in which the proceeds of disposition of property will be regarded as capital gains or taxable income.

It may be that such uncertainty is inherent in a system which distinguishes between capital and income but fails to define these terms so that it becomes necessary to consider such broad questions as what constitutes investment on the one hand, and carrying on business or an adventure in the nature of trade on the other. In any event, we do not consider that the distinction currently drawn between the two types of increment to economic power is warranted. Our proposal that all gains on the disposition of property should be treated as income would, of course, eliminate the problem of distinguishing between the two types of cases.

Under the present system, losses realized on the disposition of property are not deductible from income unless they constitute business losses, in which event they are deductible within prescribed limits. As will appear in what follows, we consider that the taxation of property gains should in general be accompanied by the allowance of property losses as a deduction from any income, a procedure similar to that we propose for business losses.

The uncertainty of the present position is a serious enough defect, and we shall speak of it further. A far more important defect is the lack of equity.

Equity

A tax, if it is to be imposed equitably, should satisfy two requirements. It should provide for horizontal equity, the equal tax treatment of persons in the same circumstances, that is, with similar claims on resources; and for vertical equity, a "fair" allocation of the total tax burden between those in different circumstances.

The first requirement would call for the same tax treatment for the wage earner who pays for his car by working overtime and his fellow worker who uses his net gains from the stock market to acquire a car. Today one acquires the car out of taxed income; the other out of a non-taxable gain. Another inequity arises because in recent years there appears to have developed a marked tendency to seek to tax gains made on the purchase and sale of real estate, but not to assess gains of a similar nature made on the purchase and sale of marketable securities. In theory both types of transaction should be subject to the same tax treatment, and there appears to be neither logic nor equity in taxing the gains on one type of asset and not on the other.

Because property gains generally become proportionately larger as income increases, vertical equity is particularly lacking under the present tax system. If property gains are exempt from tax, those members of the upper income groups who derive a major part of their revenue from property gains would pay a lower average rate of tax on their comprehensive tax bases than persons in lower income groups. Because property gains are part of the United States tax base, it is possible to be somewhat more exact about the distribution of

property gains by income class for that country. Table 15-1 shows that average capital gains, as defined in the United States, for taxpayers with incomes in excess of $200,000 exceed income from other sources, and are a large part of income in the $100,000 to $200,000 bracket.

TABLE 15-1

UNITED STATES INDIVIDUAL TAX STATISTICS, 1963

Adjusted Gross Income Class (including net capital gains) (dollars)	Percentage of Total Taxpayers Reporting Net Gains (per cent)	Percentage of Capital Gains to all Other Income a/ (per cent)
0 - 1,000	3	4
1,000 - 3,000	5	3
3,000 - 5,000	6	2
5,000 - 10,000	7	1
10,000 - 25,000	18	3
25,000 - 50,000	45	11
50,000 - 100,000	58	20
100,000 - 200,000	72	48
200,000 +	82	128
All taxpayers	8	4

a/ Gross net gains as a percentage of adjusted gross income before capital gains and losses for taxable and non-taxable returns with net gains. Gross net gains refer to the excess of gains over losses before deduction of the 50 per cent exclusion for long-term gains on capital assets.

Source: Prepared by the Commission staff from figures contained in United States Treasury Department, Statistics of Income— 1963, Individual Income Tax Returns, Washington: United States Government Printing Office, 1966.

For several reasons, these figures are not wholly applicable to Canada, but they do make it clear that the exemption of property gains from income has a significant effect on the tax base of the upper income groups. It should also be remembered that, because the percentages shown in the table are averages, there will be individual taxpayers in each group whose proportion of capital gains is even larger.

An even more striking compilation has been made by our research staff from United States data to demonstrate the effect on the progressive tax burden of the exemption or partial taxation of capital gains. Table 15-2, based on a year when the rates of United States personal income tax rose to over 90 per cent in the top bracket, shows that with taxation of capital gains at special rates, the progression flattened out after $50,000 of income at just over 30 per cent, and with no tax on capital gains the average effective rate would have dropped from 26 per cent for persons in the $50,000 to $100,000 bracket, to 20 per cent for persons in the bracket of $100,000 and over. It was assumed in each case that income other than capital gains was taxed at full rates. Although the data are by no means capable of exact application to Canada, this second comparison could well be typical of the Canadian curve of progression, because of the complete exemption here of capital gains. At least it can be taken for granted that the progression in the statutory personal income tax rates in Canada, as in the United States, bears no resemblance to the true progression that would result if capital gains and taxable income were added together. At some level, progression would very likely cease and the curve decline.

There is no doubt in our minds that as long as capital gains are excluded from income the present system will fall short of achieving the standards of horizontal and vertical equity that we recommend should be established for the Canadian tax system.

TABLE 15-2

THE EFFECTIVE AVERAGE RATE OF INCOME TAX PAYABLE
UNDER VARIOUS ASSUMPTIONS, UNITED STATES, 1962 a/

Adjusted Gross Income Class b/ (dollars)	Assuming Capital Gains Subject to Full Rates of Tax (per cent)	Assuming One Half of Capital Gains Subject to Tax c/ (per cent)	Assuming Capital Gains Exempt from Tax (per cent)
0 to 5,000	10	8	5
5,000 to 10,000	13	11	10
10,000 to 25,000	18	16	14
25,000 to 50,000	26	23	20
50,000 to 100,000	36	31	26
100,000 +	45	33	20

a/ Information only for taxable returns having capital gains or losses, but the computations exclude the amounts of net losses.

b/ Adjusted gross income for the purposes of determining the average rate of tax payable is before the deduction of the 50 per cent exclusion for long-term gains on capital assets, although the division by adjusted gross income class is based upon the amount after this deduction.

c/ These rates are imposed on the basis actually used in the United States. One half of the excess of net long-term capital gains over net short-term capital losses is included in income, but the maximum tax is 25 per cent of the total of this excess.

Source: Prepared by the Commission staff from figures contained in United States Treasury Department, Statistics of Income—1962, Individual Income Tax Returns, Washington: United States Government Printing Office, 1965.

Neutrality

In several areas grievous problems of taxation are attributable to the fact that a transaction carried through in one way results in taxable income, whereas if it is conducted in another way the gain is totally exempt or taxed at materially lower rates. One striking example of this lack of neutrality relates to the current method of taxing the income earned by corporations. If declared each year as a dividend, it attracts personal income tax; if allowed to accumulate in the corporation, it is likely to increase the value

of the capital stock of the corporation. This increase in value in excess of the earnings retained, when realized by disposition of the stock, is generally free of tax. Another example concerns the disparity in the tax treatment of the proceeds derived from the exploitation of intangible property, such as patents, copyrights, or even business goodwill. If property of this nature is retained by the owner, he pays income tax on the annual returns, but if he sells the property to someone else at a price that represents the capitalized expected return, the proceeds are often exempt from taxation. Because this type of property generally has a limited life, in both cases the taxpayer would at some time lose this source of income, so the tax differential can have a major impact on the decision to retain or sell the property. The taxation of increments in property values is essential for more equitable and neutral treatment of income from property.

It is probably safe to say that the fact that income from a transaction will be exempt from tax, if realized through the disposition of an investment or a capital asset, is at the root of much of the very considerable effort directed to tax avoidance under our present system. A long list of additional examples could easily be given to substantiate this statement further. Also, it is amply evident from the background of the capital gains tax in the United Kingdom, that the growing sophistication of taxpayers in devising means for achieving tax exemption through the capital gains route had a very substantial influence on the final adoption of the tax. We are convinced that much would be gained in Canada by bringing an end to a situation in which a tax advantage of very substantial proportions may rest on the mere form in which a transaction is carried out.

Certainty

As we observed earlier, the taxpayer is in the hands of the courts in the determination of the tax results of a transaction, and in the particular area of capital gains the courts have been unable in the past to evolve a set of tests that can be applied with certainty to many situations that arise,

and in our view they will be unable to do so in the future. The present basic concept of income is so obscure that the tax administration and the courts are required to make distinctions where no real distinctions exist. They are required to judge the motivation that guided a taxpayer to a certain result when frequently all the evidence of intention, both primary and secondary, could as easily be interpreted to indicate one intention as the opposite. In our view the present system requires both the administration and the courts to spend excessive amounts of time and skill in the making of hairline distinctions which are inevitably arbitrary, capricious and inequitable.

By what process of reasoning can it ever be decided with certainty whether it requires one, three, five, ten or fifty transactions in an article of trade to constitute carrying on a business? What ultimate test could ever be applied to determine absolutely whether a person fully intended to make a gain through the sale of property, or had only the purpose of holding an investment? By what rule of logic are gains on land suspect and those on securities inviolate? Merely to state these questions, and they are relatively straightforward by comparison with some that could be set down, is enough to show the refinements of hair splitting in which taxpayers, tax administrators and the courts are now required to indulge as a regular exercise. The only full solution to the dilemma that we can see is to adopt the comprehensive tax base and to tax in full all gains. Thus,the issue of motivation would no longer be a criterion, for a person's capacity to consume would be increased regardless of whether the gain resulted from a profit-seeking transaction or was of a windfall nature. The proposition is simple, but it would render obsolete the many guidelines that have been established over the years for determining what was in a taxpayer's mind, an exercise which was at its best unsatisfactory, and at its worst an arbitrary, inequitable and capricious way to determine tax liability.

COMPREHENSIVE TAX BASE

We have concluded that taxation at progressive rates of increments in economic power represents the fairest measure of ability to pay, and is the only means of achieving an equitable and neutral tax system. Gains realized on dispositions of property come within this concept naturally and logically. Such gains increase the taxpayer's economic power and thus enhance his ability to pay. We see no escape from the quandary in which the Canadian tax system finds itself except by the adoption of a concept under which the taxability of property gains is made clear and certain.

It appears to us, moreover, that property gains should be taxed in full as ordinary income. This proposal may seem extreme, particularly when in countries like the United States and the United Kingdom at least some such gains are taxed at reduced or preferential rates. However, we think that such preferential rates may be attributable in whole or in part to the existence of very high progressive rates of tax, or to the lack of comprehensive averaging provisions in the countries concerned. In addition, concern with the economic impact of taxation on investment may have been a major influence in the determination of the level of taxation that should apply. Unquestionably, preferential rates and the arbitrary time periods which are sometimes used for the purpose of determining whether a particular gain should be taxed as income or on a preferential basis, can add greatly, as in the United States, to the complexity of the tax legislation and to the uncertainty of its application. Tax differentials can also produce a considerable distortion in the manner in which taxpayers organize and conduct their activities. Thus, preferential rates produce complexity and a lack of neutrality and moreover, as we discuss later, they are not necessarily the most efficient way to encourage investment and to relieve inequities. With an overall concept of income, it seems to us that it is neither feasible nor desirable to distinguish between types of increments to economic power.

We shall examine these questions, and the economic impact of taxing capital gains, more fully later. We would anticipate some of the discussion that will arise regarding our proposal by pointing out the following:

1. We believe that our proposal for the integration of the corporate income tax with the individual income tax should eliminate the double taxation of corporate source income that could otherwise exist with the taxation of share gains.

2. Our proposed personal income tax schedule has a top marginal rate of 50 per cent, and the taxation in full of capital gains under such a schedule should not be considered in the same light as taxation under a schedule, such as is now applicable, with a top marginal rate of 80 per cent.

3. We propose several averaging devices in respect of lump sum receipts of income that would also apply to the disposition of capital assets.

Making allowance for the fact that a tax on property gains would exempt gains that had accrued prior to the date of its coming into force, we believe that the proposals we set forth in this chapter represent a fair and workable system that would help greatly to achieve the objectives we have established for a revised Canadian tax structure.

FURTHER CONSIDERATIONS

Before discussing the proposals in greater detail, it is desirable to give further attention to some of the aspects of a tax on property gains that are a cause of concern to many persons.

Economic Implications

We discuss the economic effects of the taxation of property gains in greater detail in Chapter 37 as part of the discussion of the economic impact of all our tax proposals. In this chapter we limit ourselves to a

discussion of some of the specific economic problems that might arise if our proposals for the taxation of property gains were implemented.

The taxation of property gains is clearly called for on grounds of equity. However, if such an extension of the tax base would have adverse economic effects that were not offset by other measures, it would not be an unequivocal improvement.

We agree with the opinion expressed by many economists in the United States that the taxation of property gains has had very little effect on the level of investment in that country.

<u>Effect on Savings</u>. It is sometimes argued that the taxation of property gains would both reduce the rate of saving and make risky investments less attractive and that the reduction in the rate of economic growth is more significant than the resulting improvement in equity.

Assuming the same total tax revenue was raised, the taxation of property gains could reduce the rate of saving in two ways:

1. Personal saving would decline if those with increased tax liabilities reduced their saving by more than those with reduced tax liabilities increased their saving.

2. Corporate saving would be reduced if the taxation of property gains resulted in increased corporate cash distributions and shareholders did not increase their savings by the amount of the additional dividends.

We are satisfied that the first argument does not warrant concern. Taxing property gains, together with all other reforms, would increase the taxes borne by most taxpayers. The individuals and families in these classes undoubtedly save a higher proportion of their incomes than those in the lower income groups for whom we propose tax reductions. This means a substantial proportion of the increased taxes on the well-to-do would be financed through reduced personal saving. Only a small fraction of the reduced taxes on lower and middle income taxpayers would be saved. The net effect on personal saving would be almost certainly negative. But while the direction of the effect would be unfavourable to domestic saving, the magnitudes involved would not be substantial. It must

be constantly kept in kind that, while we propose to tax capital gains in full, we are also proposing other changes, in particular personal and corporate integration and lower rates of personal income tax, that would tend to reduce the taxes paid by middle and upper income tax units. Also, it must be recognized that the taxes paid by these tax units are a relatively small proportion of total revenue. All of our proposals taken together, including the higher initial taxes necessary to cover transitional costs, would probably not increase the personal tax liabilities of tax units with incomes of over $15,000 a year (defined in accordance with the comprehensive tax base) by more than $150 million. Even if the whole of this tax increase was financed by reduced personal saving, total personal saving (currently about $3 billion) would only be reduced by about 5 per cent. There would be no appreciable impact on total domestic saving of approximately $11 billion.

The second argument would concern us if the proposal to tax property gains was made in isolation. There can be no doubt that the failure to tax share gains biases the system in favour of corporate retentions. If this bias were not only removed but was reversed, corporate savings could be significantly reduced. The adoption of our integration proposal (Chapter 19) would, however, ensure that there was no double taxation of retained earnings and would also reduce the pressure on management to increase cash dividends.

The integration system requires the allocation of corporate earnings to shareholders and does not require the distribution of cash in order to give the shareholders the right to credit for the underlying corporate tax. Management could, in effect, substitute tax credits for increased cash dividends. Because the interest of management is almost always to retain cash within the corporation, we are convinced that the net effect of the taxation of share gains and corporate-personal integration would not be to increase total corporate cash distributions. Indeed it is more likely that some reduction in corporate cash distributions would occur. Despite the full taxation of share gains and despite the removal of special industry concessions and despite the withdrawal of the lower rate of corporate tax, we estimate that adoption of our integration proposal would reduce the tax revenue derived from Canadian corporate source

income of residents by more than $100 million. We are convinced that some of this tax reduction at the personal level would be offset by a slower rate of increase of cash dividends and a correspondingly greater increase in corporate saving.

Taxing property gains would undoubtedly change the relative attractiveness of different kinds of investments. Other things unchanged, assets that provide a return with a high property gain component, not now taxed, would be relatively less attractive. Here again, for some assets we are recommending other changes in the tax system that would offset this effect. The integration proposal, when combined with the taxation of share gains, would reduce the marginal rates of tax on the total return from most corporate shares for most Canadian shareholders. Low and middle income shareholders in particular (and the institutions that make investments on their behalf) would find holding corporate shares more attractive relative to other assets than at present. The cost of equity capital to Canadian corporations would be reduced, thus encouraging an increase in the rate of investment by most corporations.

Our proposal to allow accelerated depreciation to new and small businesses, coupled with the treatment of losses we also recommend, would provide an added incentive to invest in new, risky ventures.

Our recommendations to tax property gains would undoubtedly make investment in some assets less attractive. For example, investments in real property and speculative mining and petroleum shares would be relatively less attractive because after-tax expected rates of return would be reduced. But we have no doubt that by inducing more new investment in other corporate shares and in new and small businesses, the rate of increase of future output in Canada would be enhanced despite these negative effects.

If after our recommended system was implemented the rates of national saving and investment were not adequate, there are a number of methods of increasing the growth rate that would be more efficient and more equitable than the preferential tax treatment of property gains. These methods are discussed in Chapter 4.

<u>Effect on the Rate of Turn-Over of Security Holdings</u>. Another question raised by the taxation of property gains, when it is limited to a realization basis

as we recommend, is the effect on the rate of turn-over of security holdings. Because our proposed method of taxation would have the same effect on security transactions as a transactions tax of the same magnitude, obviously it must to some extent restrict the turn-over of assets. Therefore, it is necessary to examine whether this effect would be so great as to have a disruptive influence on Canadian security markets. Because publicly traded securities are the most widely held form of investment, it is with these assets that our concern is greatest.

To the extent that our proposal for the full taxation of share gains has an impact on publicly traded share turn-over, it will primarily affect transactions by individuals who have acquired the shares as a long-term investment. Stock exchange members and other individuals engaged in trading activities acquire shares in anticipation of an early change in the market price and generally dispose of the shares after a short time (say, less than six months) regardless of what happens to the price. These persons are already taxed on their gains or, if not, are generally engaged in short-term buying and selling activities which would be relatively unaffected by the measures we propose. Pension funds and other intermediaries dealing in shares for Registered Retirement Income Plans will not be taxable so that their trading would not be affected by our proposal.

According to surveys conducted by the two major stock exchanges in Canada, individuals acquiring shares with the intention of retaining them for more than six months make up less than one half the trading activity. Of the business conducted on the Toronto Stock Exchange on the days selected, less than one half was for the account of such individuals, while the percentage for the Montreal Exchange was under 20 per cent 5/. Thus, the potential impact on mobility of the full taxation of capital gains is limited to something less than one half the trading activity.

We attempted to ascertain what the influence on these investors of

our proposal would be by reviewing a number of studies that had been completed in the United States and by conducting our own survey of share transactions by taxpayers with incomes exceeding $25,000.

The various studies in the United States have attributed different degrees of mobility effect to the taxation of share gains. Unfortunately, the most ambitious study in this regard concentrated the analysis on the level of taxation of realized gains, and ignored the effect of the United States tax exemption on gains accrued at death 6/. Therefore, the view stated in the study that a reduction in the level of taxation on capital gains would substantially increase the turn-over of securities is not conclusive. Other studies have indicated that the tax exemption on gains accrued at death does reduce mobility, while concluding that the taxation of realized gains, at the United States preferential rates of tax, has only a limited influence on security transactions. The sharp declines in the general level of stock market prices which occur from time to time probably have a much greater effect on the mobility of capital than would any reduction in the taxation of share gains.

Our research staff reviewed the number of securities sold in 1961 and 1962 by a sample of high income Canadian taxpayers 7/. Unfortunately, we were unable to conclude whether the mobility of securities in Canada was greater or less than that in the United States, because the United States studies do not give enough information to provide a comparison with the data gathered for Canada. However, our survey does indicate that for most Canadian taxpayers in the upper income groups the proportion of their total portfolio that was disposed of in these years was relatively small, despite the fact that this country does not generally tax the profit from stock transactions. We did not collect data on taxpayers with incomes of under $25,000, but for them the proposed level of tax on property gains would be much less significant.

Even though the present rate of turn-over of security holdings appears to be low in Canada, the taxation of gains at full personal rates of tax could well reduce it further. This pressure toward a reduction in mobility is, however, at least partially offset by two other influences. The investor who held a stock selling at more than his cost would supposedly weigh the immediate tax cost of a disposition against a potential fall in market price, as well as compare the prospective yield from the net after-tax proceeds to the current yield being obtained. To cause immobility, the known tax cost would have to exceed the possible decline in the share price, and exceed it by a sufficient margin to reduce the yield on the prospective investment below that expected on the current investment. In addition, because every Canadian taxpayer would know that at his death or that of his spouse tax would have to be paid on accrued property gains, the value of tax postponement would be reduced. Regardless of the amount of tax, it would, of course, generally be most profitable to dispose of a stock holding when its price was at its highest level.

Later in this chapter we suggest that, some time after the adoption of a comprehensive tax base, provision should be made for the periodic revaluation of publicly traded securities by taxpayers, who would take any changes in value into account in computing their incomes. Such a measure would substantially eliminate whatever immobility was occasioned by the taxation of property gains on a realization basis only.

Preferential Treatment

Lower Tax Rate. Although property gains are generally taxed at preferential rates in other countries, we have concluded that because taxable capacity depends on the amount of a receipt, and not at all on its source, equity requires that all receipts, including property gains, should be taxed at full rates.

It may be argued that, when increases in the price of shares are a reflection of the growth in the retained earnings of a corporation, the taxation of share gains would mean that part of the earnings of the corporation had been taxed twice.

It should be recognized, however, that on average the prices of corporate stocks in the postwar period have increased more rapidly than retained earnings. The additional increase in prices during this period is a reflection of a more optimistic current estimate of anticipated future after-tax earnings than was made earlier; and therefore some part of the increase is not, in the first instance, a gain that has already been subject to income tax in the underlying corporation. However, we think that the question of double taxation of retained earnings would be of little significance if the corporate tax were integrated with the individual tax, as we recommend in Chapter 19. We anticipate that if our recommendations were adopted most corporate income would be distributed to shareholders in one way or another for tax purposes. That part which was distributed in cash would not be subject to double taxation. That part which was allocated to shareholders for tax purposes in the other ways contemplated under our integration proposals would increase the cost basis 8/ of the shares to the shareholder so that he would not be subject to double taxation on earnings retained in the company if he sold his shares.

Substantial administrative problems would be attached to any differentiation in rates. Just as exclusions and exemptions from income lead to administrative complexities, so would the preferential treatment of any type of income also increase administrative difficulties. The complexities of the United States Internal Revenue Code could be greatly reduced if all property gains were taxed at full rates; the major complexities are not the result of taxing such gains, but of taxing them at preferential rates.

For these reasons and because we recommend suitable averaging provisions, we believe that the only grounds on which we could justify preferential rates of tax for a particular type of income would be as an economic incentive. Therefore, it is important to discuss again the relationship between dividends and gains on capital stock. We believe that investors would be generally indifferent as to whether they received their return from capital stock in the form of dividends or gains, as long as their total after-tax income is the same. At the present time in Canada, dividends usually attract some tax liability while gains are generally free of tax, a situation that tends to encourage corporate retentions and is therefore the basic cause of the surplus-stripping problems, that is, the realization of cash from a corporation with retained earnings in such a manner as to reduce or eliminate the tax liability of the shareholder. However, it would be just as undesirable to reverse the situation so that dividend pay-outs would be encouraged. Therefore, for reasons of tax neutrality, we regard it as a matter of some importance that both forms of yield on capital stock should be taxed at approximately the same levels—an objective that would be attained if our proposals were implemented.

The taxation of gains on corporate stock need not depress security prices. In fact, an overall rational approach to the taxation of corporate source income that considered taxation at the corporate level, in the hands of intermediaries, and when ultimately received by the individual, could result in a substantial rise in stock prices. The effect of taxation on the stock market depends upon the taxation of income in general, and corporate source income in particular, and not merely on the taxation of gains on corporate stock. Thus, the increase in demand for securities that we anticipate would follow from the implementation of our proposal for the taxation of corporate source

income and from our suggested procedures for taxing financial institutions should offset any adverse influence that might be expected to result from the taxation of gains on corporate stock. The reduction in the net cost to a taxpayer of incurring losses, because they would become deductible, should also have a favourable effect.

There is little to be said for the view that an exemption from tax for property gains or the taxation of such gains at preferential rates would act as a stimulus for an expanding economy. Further discussion of the effects of our proposals on equity prices is contained in Chapter 37.

We have not suggested that preferential treatment should even be considered for other forms of property gains. None of the reasons that might suggest a preference for capital stock gains appears to apply in a material way to other forms of property. In addition, the more extensive the preference, the greater the complexity and uncertainty that would result. In particular, even if a preference were granted, it would be imperative that it be related to the substance and not to the form of a transaction. There is little economic advantage in granting incentives only to those who are able to arrange their affairs in the appropriate manner.

Holding Period. A number of other jurisdictions vary the tax rates applicable to property gains according to the length of time a property was held. Arguments have been advanced that a reduced rate of tax for the gain on long-term assets gives recognition to the fact that a gain when realized may represent a value that has accrued over a long period of time.

We reject this line of reasoning. The phenomenon of a large amount of income being realized in one year after accruing for many years is

not an unusual one, and there are a variety of ways of averaging income to ensure that progressive tax rates do not unduly erode such a receipt. We propose in this Report the adoption of several methods of averaging, but we reject the principle that a substantial part of any income should be exempted from tax simply because the time over which it accrued exceeded six months or one year or some other arbitrary period. We see nothing to distinguish the realization of such a gain on property from a lump sum receipt of income in any other form, and our proposal therefore is that no concession should be granted for realized property gains beyond the averaging devices we propose in Chapter 13. In any case, we are satisfied that the combination of the averaging proposals with the proposed rate schedule would ensure that no taxpayer would incur a substantial increase in progressive rates because of a large lump sum receipt. Thus, with a maximum rate of personal income tax of 50 per cent, and the opportunity to average a gain over an extended period by combining our block averaging proposal with the temporary use of the Income Adjustment Account, the taxpayer should be able to alleviate any potential hardship of applying progressive rates to a substantial gain.

Another argument that has been advanced in favour of holding periods is that they could be used as devices for determining eligibility for preferential treatment, the intention being to deny the preference to the so-called speculator. The speculator is arbitrarily deemed to be the person who completes his transaction within a specified period, six months in the case of the United States, and therefore preferential treatment is extended only to those who delay disposition beyond such a time period. In this sense the United States has perpetuated the distinction between "carrying on business" and "investing" which we find so unpalatable in the present Canadian position. In addition, the test is one that even the so-called speculator can satisfy with little difficulty. The distinction is not only artificial and arbitrary, but also ineffective if the criterion for the

preference is such that virtually any shareholder can readily qualify for the benefit. We have concluded that the holding period approach would introduce complexities into the legislation without achieving its intention.

In any case, the significant consideration is that in equity we see no justification for preferential treatment for any form of gain on transactions in property. We have set out how problems of lump sum receipts can be dealt with adequately, and in our view all realized increases in economic power, regardless of their source, should be equally a subject of taxation.

Inflation and Interest
Rate Effects

Another question that is often raised relates to the equity of taxing gains accrued over a period of time during which there has been inflation or a fall in interest rates.

It has been argued that it would be inequitable to tax a gain that resulted from a general increase in the price level. The point is made that such a gain is illusory because it does not represent any real increase in purchasing power. This argument, when used to support the exemption of stock market gains, appears over-emphasized if the substantial increases in the stock market averages are compared with the rather smaller increase in the cost-of-living index. In addition, we cannot overlook the fact that there are many members of society with fixed incomes who suffer losses in economic power because of inflation and are unable to protect themselves against it. This is in contrast to the equity holder who, during a period of inflation, will generally experience some growth in the dollar value of his assets. Because it is not possible to make provision for complete recognition of declines in purchasing power brought about by inflation, we have concluded that it should not be the function of the tax system to attempt to relieve only some segments of the population from the effects of inflation. The tax system should therefore, in our opinion, continue to be based on current dollars and not on constant dollars.

Fluctuations in interest rates necessarily bring about inverse changes in bond prices. It is sometimes argued that the gains and losses from buying and selling bonds are therefore illusory in some sense and should not be subject to tax like gains and losses on other assets. It cannot be denied that taxing realized gains on any asset can have a deleterious effect on the mobility of capital. This "locking in" effect is not unique to bonds and we can see no reason to differentiate gains and losses on bonds, from gains and losses brought about by changes in rents, dividends, and other returns on other assets. Increases in bond prices relative to other prices increase the economic power of the bondholder and should be taxed; and conversely for reductions in bond prices.

Roll-Over Privilege

Another issue concerning taxpayer equity is the proposition that, if property gains in general are to be taxable, there should be an exemption to the extent that the proceeds received on a sale are reinvested in other investment property. This "roll-over" procedure has an apparent attraction in its encouragement of reinvestment by postponing taxation of realized property gains that are reinvested. However, we find the proposition to be a serious violation of equity. In effect, the suggestion is that those who accumulate saving from realized but reinvested property gains shall be free of immediate tax, while those who save from other income must pay full rates of income tax at the time the income is received. We are unable to find any rationale for a system that would enable some property owners to save from pre-tax dollars, while others must save from after-tax dollars. If such a substantial incentive to investment and saving is considered to be desirable, we discuss in Chapter 4 a number of alternative ways to provide it without discriminating among any of the sources of saving. The proposals outlined in Chapter 16 for Registered Retirement Income Plans do not discriminate between sources of income and would be a strong inducement to saving.

In addition to the serious inequities that would be produced by a roll-over provision, there would also be major administrative problems in determining what income should be eligible for such a provision and to what extent. We examined in detail a number of alternative methods of providing for a roll-over and found them all to be subject to major complexities and serious definitional problems.

Revenue

It has been argued strongly that there should be no change in the tax base unless the additional revenue to be produced were substantial. This proposition is unacceptable to us, because we believe that a fair sharing of the total tax burden would be a goal to be pursued even if it resulted in no change in total revenue. Naturally, any proposed alteration in the tax base would be warranted only if it were administratively feasible. We are satisfied that the comprehensive tax base would, after the initial transition period, have administrative advantages which would far outweigh short-run difficulties. We reject any policy under which any form of income would be relieved of taxation on the ground that it contributed little to total revenue, or that the cost of collection exceeded a nominal percentage of the revenue collected.

It is not possible to estimate with any degree of accuracy what the net revenue effects of the taxation of property gains and the allowance of property losses would be in any one year. Because such gains are now tax free, there are no figures available to indicate their magnitude. Moreover, even if such figures were available, any projection would be questionable because of the variations in this type of accretion to wealth. However, there are statistics available on the United States experience and it is possible to arrive at a general estimate of Canadian revenues based on these figures. It has been possible to adjust this estimate fairly readily to take account of a number of our proposals, because of the statistical material that is available. Thus, adjustments were made to reflect the taxation in

full of all property gains, the full allowance for all property losses, the inclusion as a disposition of a gift or bequest, and the lowering of the top marginal rate of personal tax to 50 per cent. However, the impact of our proposals for the integration of the corporate tax on the revenue to be derived from the taxation of property gains is much more difficult to estimate. Ignoring the effect of the integration proposals, we are satisfied that in the long run the revenue from the full taxation of property gains of resident individuals would exceed 10 per cent of personal income tax revenue, or something less than what the United States percentage would be for similar gains if they adopted the same procedures 9/. Based upon the average rate of tax in Canada in 1964, this would have amounted to about $300 million, while the taxation of corporate property gains would have resulted in about another $80 million of revenue. It has also been assumed that the proportions of income derived from each of the general sources of income would remain unchanged, with total property gains realized by Canadians forming a lower proportion of their total income than they do for United States taxpayers. Because these assumptions are conservative, and because property gains tend to be concentrated in the growing middle and upper income groups, we expect that the percentage would increase over time. In the short run, however, the revenues would be nominal, because only gains accruing subsequent to the change in legislation would be affected, and because the other transitional provisions we recommend would temporarily reduce the potential revenue.

The net effect of taxing corporate source income on an integrated basis would be to eliminate most of the retained earnings element in share gains 10/. However, the goodwill element in share gains would remain and might well increase because of improved after-tax rates of return from integration, and because the resulting increase in the rate of fixed capital formation should stimulate share prices. On the basis of experience in the United States, where stock gains make up over one half of the total reported property gains, the potential revenue from the taxation of property gains in Canada, based upon average rates of tax, would probably be considerably less than the figures given above. Detailed estimates of the overall revenue implications of the taxation of corporate source income are contained in Chapter 35.

THE PROPOSAL IN OUTLINE

The following summary gives a general outline of the main principles we think should apply in the tax treatment of property gains and losses. In subsequent pages some of the major questions which arise will be discussed.

Gains should be included in income when they are realized, that is, on the disposition or deemed disposition of property. The concept of realization or receipt of income was discussed in Chapter 9 and the difficulties of defining these terms were outlined there. In the case of property gains we are suggesting that a realization should be deemed to have occurred when there has been a disposition, as we employ the term, even if the disposition does not in itself result in the receipt of cash. We have already discussed the major problems that an approach of this nature can produce: the breach of the ability-to-pay principle if gains are not taxed as they accrue to the benefit of the taxpayer, and the problem of lump sum income receipts if gains accruing over many years are taxed at progressive rates in one year. Taxation on an accrual basis will be discussed later in this chapter, while several income-averaging proposals are described in Chapter 13.

1. Persons taxable should include residents, both individual and corporate, and they should be taxed on their world gains, just as they are now taxed on their world income. The foreign tax credit should therefore extend to foreign taxes on property gains.

   A non-resident carrying on business through a permanent establishment in Canada should be taxed on gains on property employed in that business, but should not be taxed on gains on the disposition of other property until a satisfactory means can be developed of assessing the tax and enforcing its collection.

2. Gains on all forms of property should be included in computing income, subject to a limited exception for certain residential, including farm, properties.

3. While all losses should also be taken into account in computing income, no deduction should be permitted for losses that are in effect items of personal consumption. To accomplish this objective, all losses should be deductible except to the extent that they resulted from the disposition of property that has been held for personal use or consumption, or resulted from an activity that could not be reasonably related to the earning of income.

   Although, in general, a loss should be allowed as a deduction only if a disposition has taken place, we also suggest that a deduction should be permitted when there has been no disposition, provided that a loss could be shown to have actually occurred. It would not be necessary to show that the loss was of a permanent nature.

4. The term "disposition" should be used in the broadest sense. It should include voluntary dispositions, such as sales or exchanges of property, and involuntary dispositions, such as occur on the loss of property. It should also include most changes in the form of property, even if one person held ownership throughout the transaction. In addition, the termination of a contingent interest in property or of an option to acquire property should be treated as a disposition.

   These rules would mean that gifts and bequests, which are voluntary dispositions of property, would be treated as dispositions for tax purposes at the fair market value, as we think they should be. Moreover, certain events should be deemed to result in dispositions. Thus, whenever an individual or a corporation becomes or ceases to be resident in Canada, there should be a deemed disposition of the property of that person, while on a person becoming resident in Canada there should be a deemed acquisition by him of his property at the fair market value.

However, certain events affecting property should not be treated as dispositions, so that their occurrence should not give rise to a gain or loss. Among these events, if they qualified in the prescribed manner, we would include the following:

a) A loss or destruction of property that gave rise to payment of insurance or damages if such proceeds were reinvested in similar property within a reasonable time.

b) The expropriation of property if the proceeds were reinvested in similar property within a reasonable time.

c) The transfer of property to a corporation when a business was incorporated.

d) Exchanges of shares and transfers of property on certain corporate reorganizations.

e) The pledging of property by way of security for an obligation.

5. When a disposition occurred, the gain or loss should be determined by deducting the cost basis of the property from the net proceeds of disposition.

The net proceeds of disposition should be the consideration received, less any expense of the disposition. On gifts or deemed dispositions, the proceeds should be taken to be the fair market value. The cost basis should include the original cost of the property and most costs incurred to enhance or to protect its value. In particular, it should include any interest and property taxes which the taxpayer elected to add to his cost basis rather than to deduct as a current expense. There would also be other adjustments to the cost basis in certain events.

Partial disposals would require an apportionment of the cost basis,

using either an average cost, first-in-first-out, or some other reasonable basis of allocation.

6. Annual tax returns should include appropriate information as to all securities and real property owned. Particulars of all property gains and all deductible property losses would also be required.

7. The taxation of property gains should not be retroactive. Gains on property held on the transitional date should be taxable only to the extent that the proceeds of ultimate disposition exceeded the fair market value at the transitional date.

   Publicly traded securities should in most cases be valued at their market value as at the transitional date. For other property the taxpayer should be allowed to value his property as at the transitional date, or alternatively to wait until disposition and then to apportion any gain or loss, on a time basis, between the periods before and after the transitional date. A partial exemption for gains determined under the second alternative would make this alternative attractive and should reduce the number of detailed valuations required.

Persons Taxable

The taxation of residents poses few difficulties in determining who would be taxable, beyond those difficulties already encountered under the present law. However, the situation would be more complex where non-residents were concerned.

The general approach to the taxation of non-residents, that we develop in Chapter 26, is that income derived from Canada should be subject to some Canadian income tax. Accordingly, the levying by Canada of some tax on gains realized by non-residents on the disposition of Canadian property would appear to be in order. However, the administration and collection of such

a tax would in many cases be difficult, if not impossible, because of the problem of determining when a disposition by a non-resident had taken place, and the further problem of enforcing the collection of any tax imposed. Therefore, we do not propose that property gains of non-residents should immediately become taxable in Canada, unless a non-resident carried on business in this country through a permanent establishment and the gain was on property employed in that business. However, if procedures could be developed that would make it feasible to tax other gains of non-residents, Canadian tax should be assessed on this type of income in the same way as on other income derived from Canada.

We also recommend that the definition of "permanent establishment" should include real property and mining and petroleum rights owned in Canada by a non-resident, who would therefore be taxable on gains on the disposition of such property. This would require that non-residents also be taxable on the disposition of shares of closely held companies used to hold real property. If these measures were not adopted, the non-resident owner of real property would have a competitive advantage over the resident.

Gains for Tax Purposes

We propose that gains on all forms of property should be taxed, property being broadly defined as in the present Act, subject to the exclusion provided for below. We do not believe that any other form of gain should be excluded on the grounds of equity or administrative complexity. However, if some other specific item should be excluded, it would have to be defined. We do not suggest that the Act should specify all items to be included in income, but rather that it specify any items that are to be excluded. The latter approach minimizes taxpayer uncertainty and the inequities that could otherwise arise.

We recommend an exception for property gains realized on the sale of residential (including farm) properties up to a lifetime total of $25,000

of such gains for a family unit or an individual. Although the reasons for this exclusion are largely administrative, there are also social implications. The complexities in maintaining adequate cost records over the periods involved if gains on residential properties were taxed would be considerably greater than would be involved for other types of property. In addition, the taxation of gains on such properties would give rise to pressure to have losses of a similar kind allowed, even though the losses might reflect in large measure costs of a personal consumption nature such as depreciation of a dwelling. Also, some form of roll-over provision, despite all its attendant complexities, might be demanded. We therefore recommend an exclusion, but an exclusion limited in some important respects.

Residential properties and adjacent lands used by the taxpayer as a residence should be eligible for the exemption. All property owned and operated by bona fide farmers should also be eligible, provided it had been worked as a farm unit by the owner for not less than two years. At least for a transitional period, the trade or business test should continue to apply in order to tax gains arising from trading in such real property. The lifetime dollar limit would reduce the significance of the trade or business test, and also would make it unnecessary to impose an acreage limitation on the exemption as was done in the United Kingdom. To relieve most taxpayers, other than qualified farmers, from the necessity of maintaining detailed records of improvements, we suggest that the cost basis of residential property could be determined, by election, either on an actual basis or by adding to the original cost basis 1 per cent of the cost of the buildings for each year the property had been held. If the actual basis were used, then the same considerations would apply as at present in determining whether an expenditure was a repair item or an addition to the capital cost. In addition, as we indicate later in this chapter, it should be possible to add to the cost basis property taxes and interest, except to the extent they were disallowed as personal expenditures. These latter expenditures would therefore be available for deduction by qualified farmers, but generally not by the

holders of residential real property. Property held at the effective date of the new legislation could be valued at either cost or the appraised market value at that date. A taxpayer using property jointly for personal living and business would be required to allocate his costs and expenses between the two. There would be pressures to make a reasonable allocation, because only business depreciation would be deductible, while only personal gains on the sale of residential property would be exempt. If members of a family unit filed separate returns and each had eligible gains, the exemption would be apportioned between them.

Losses for Tax Purposes

Deductible Losses. Because we recommend that all realized gains should be brought into the tax base, equity requires that all realized losses should be applied to reduce the tax base. Subject to what follows concerning property employed in personal use, we recommend that losses realized from dealings in property should be deductible in full from all other forms of income. This deduction would be considerably more liberal than that existing in other countries, 11/ and parallels our recommendations elsewhere in this *Report* for the treatment of business losses. Although this proposal might prove expensive to tax revenues in years of declining asset values, we feel that not only would it result in a tax base that would be a better reflection of taxable capacity, but that it should provide an incentive for risk investment. It also has other very desirable economic implications, in particular for stabilization policy. Further discussion of the economic effects is included in Chapter 37. It should also be noted that our studies of the taxation statistics for the United States suggest that the loss limitation there places little restriction on the higher income groups, who soon realize compensating gains, while many in the lower income brackets appear to have to carry forward a loss which in effect becomes non-deductible.

We therefore recommend that the loss carry-over provisions that we suggest for business losses in Chapter 22, a carry-back of two years and an

unlimited carry-forward with the loss being deductible from all other kinds of income, should also apply to losses on the disposition of property.

Non-Deductible Losses. The general proposition for the deduction of losses has, however, serious implications as regards principle and administration. We do not intend to recommend the deduction from the tax base of items of personal consumption; thus, for example, depreciation or losses on assets employed for personal use should not be deductible. The primary obstacle to an allowance for a capital loss realized when a consumption asset is lost through damage, destruction or theft is one of determining the depreciated value of an asset at the time of loss. There would also be a problem of enforcement under a tax system which would disallow a deduction for partial losses, through depreciation, but would permit a deduction of a complete loss, through destruction. In addition, a tax system that permitted the deduction of such losses should logically allow the deduction of expenses incurred to reduce the amount of these losses. Any listing of such expenses would be lengthy, and the administration of such an allowance would be complex and uncertain. Therefore, the inability of the taxpayer, and even more the inability of the tax administration, to ascertain accurately the gain or loss from the depreciated value arising on the disposition of personal assets, as well as the additional administrative difficulties involved, have led us to the conclusion that it would be necessary to disallow all losses on property held for personal use, including losses arising on the disposition of a residence.

Losses on the Disposition of Property. The above conclusion in turn leads to the question of how best to determine whether property has been held for personal use. The recent legislation in the United Kingdom speaks of "tangible movable property", and exempts gains and losses that are within a prescribed monetary limit. It is difficult to assess, at least until some experience has been obtained, whether such a provision is the best way to meet the problem. We have already recommended that the deductibility of expenditures

should be limited to those outlays that are reasonable, are related to the earning of income, and are not for personal use or consumption. The jurisprudence on the last test has already established a number of limitations on deductibility, and we expect that the courts would continue to develop the necessary concepts to determine those expenditures that were a proper charge against income. It therefore appears reasonable to apply the same tests to losses in order to establish their deductibility. Thus, for property losses a deduction should be permitted if at the time of disposition the purchase of the same property for the same use would be deductible at some time, under the statutory rules that we recommend. An approach of this nature would unfortunately produce some uncertainty, but after examining a number of alternatives we are satisfied that it would be the only way to ensure that all reasonable property losses would be deductible. Nevertheless, we shall describe later an alternative approach that might be applied if the definitional problems become excessive.

The proposed allowance of losses on the disposition of property parallels that recommended for business losses, and therefore means that in most circumstances there would be no significant difference between business gains or losses and property gains or losses; an approach that would have the obvious advantage of eliminating much of the existing uncertainty in the Canadian tax system. Therefore, we recommend that all gains should be included in income, including any gain on the disposition of an item of personal property, but we recommend that the general allowance of all losses should be restricted by denying a deduction for losses of a personal nature.

In relation to business losses we have proposed an arbitrary rule to the effect that, if such losses have been incurred in three years during a five-year period, and, if subsequent gains from the same business do not exceed these initial losses, then subsequent losses would be regarded as losses of a personal expenditure nature and could be applied only against income from the same business for other years. This rule is obviously not applicable

to losses incurred on the disposition of property (unless it is property employed in such a business) since various types of properties might be disposed of during a period of years and the fact that net losses were incurred would not lead to any implication that any particular property was acquired or used for personal consumption. The question of whether property losses are of a personal nature, so that their deduction would be restricted, would have to be determined on the facts of each case unless it should be found necessary to adopt the alternative approach which we will refer to later.

The possible inequity of taxing gains on some transactions, for example, on property for personal use, while disallowing losses on similar transactions, is more apparent than real. Only where the sale price of property held for personal use exceeded the original cost, rather than the depreciated value, would the excess be subject to tax. It is unlikely that there would be many items of this nature, and if they were material, the possibility would exist that they were acquired with a business motive. The possible inequity of not allowing a deduction for the loss or destruction of personal property that might result in a substantial reduction in taxable capacity is not great, because most consumer durables can be easily insured to provide sufficient protection against such an eventuality.

The major potential inequity in the above approach relates to gains and losses on certain kinds of property that are of a personal nature but that are not actually consumed. The chief examples are works of art and jewellery. It seems to us to be equitable to make some provision for any losses on such property that might arise. Therefore, we recommend that the legislation specifically permit the deduction of most losses on the disposition of property that would otherwise be disallowed from gains realized on the disposition of similar kinds of property in the preceding two years, in the same year, or in any succeeding year. This provision matches the one we recommend for "business" losses that were or were deemed to be of a personal nature.

Losses on the disposition of residential real property, which are losses on property held for personal use and not therefore deductible, should not be eligible for this carry-over. Losses on the disposition of personal property result mainly from two processes: the "using up" or depreciation of the property, and the gain or loss in the value of the property caused by external influences unrelated to wear and tear. The latter process would usually result in a gain, unless a loss of a casualty nature had occurred, for example, a fire. Losses resulting from depreciation should clearly be excluded from the tax base as being of a personal nature, while gains or losses of the second kind are similar to those arising from the disposition of other kinds of property and should, in principle, be included in the tax base. As already pointed out, it is difficult, if not impossible, to segregate a gain or loss on the disposition of personal property into these two elements. As a result we recommend that in the case of property held for personal use only the net gain, that is, the excess over the depreciation loss, should be taxable and that no loss should be deductible, even if no part of the loss was attributable to depreciation. We have suggested that, to relieve the inequity that such a provision might cause to a taxpayer who disposed of a number of items of the same kind of property, any losses should be deductible from gains on the disposition of similar property. However, the extension of this concession to residential property would not be warranted. If a taxpayer has a number of transactions in this kind of property he might well be engaging in a form of business or investment. In addition, the depreciation element in residential property is substantial, and a loss carry-over would only benefit those who are in a position to derive substantial speculative gains on an increase in land values. Furthermore, any potential inequity in the procedure we recommend should be more than compensated for by our recommendation that there should be a lifetime exemption of $25,000 in residential property gains for each tax unit.

The farm property of a bona fide farmer should not be classed as personal property for this purpose, and therefore losses incurred on the disposition

of such property would be allowed as a deduction from any income. However, it would be reasonable to provide that, before a property gain could qualify for exemption under the $25,000 allowance, it would be necessary to "recapture" any property losses on farm property which had previously been claimed as deductions from other income.

Operating Losses on the Holding of Property. In Chapter 9 we recommend that while business losses and losses incurred on the disposition of property should be deductible from other income, subject to certain limitations, operating losses arising from the holding of property should not be deductible from income arising from other sources. We recommend this treatment because we believe it would be the most appropriate way to match income and expenses for tax purposes. The difficulty in matching income and related expenses arises because property is often held with a view to eventual disposal at a profit. Because the increment in property value is not brought into account until it is realized, it would not be reasonable to permit the annual deduction of operating losses that represented the carrying costs associated with such ultimate gain. An additional consideration is that it would often be difficult to determine to what extent a property was held in anticipation of a gain, and to what extent it provided the taxpayer with a personal benefit. By not allowing these losses to be deducted from other income, but rather permitting them to be carried back two years and forward indefinitely for deduction from operating income (but not gains on disposition) from the same property, the desired objective should be attained. To alleviate the difficulties which such a limitation might otherwise cause, we recommend that certain expenditures that are commonly thought of as being a cost of current operations, but that are also costs of "carrying" the property, should be permitted to be capitalized. Thus, costs that were primarily related to the holding of property, with a view to its later disposal at a gain, could be added to the cost basis of that property. This would reduce the current operating expenditures, and therefore the current losses, and would match the expenses more closely to the expected revenue, that is, the property gain. The capitalization of these expenditures would be optional to the taxpayer.

Although there are a number of kinds of expenditures that might be eligible for capitalization, we consider the prime examples to be interest and property taxes. The costs of establishing or defending title to the property, and damage costs related to the ownership of the property are also items which should reasonably be eligible for capitalization. Where property is clearly of a personal consumption nature, such as residential property or consumer durables, carrying charges such as interest and property taxes should not be deductible, and the taxpayer should not be able to capitalize them or add them to the cost basis of the property.

Alternative Treatment of Losses. In the event that the procedure we recommend for limiting the deduction of losses of a personal nature proved difficult to administer, we suggest as an alternative that the Act permit only the deduction of losses that were specifically defined, and that items of property employed in personal use should not be included in the list of allowable losses. The list, apart from business losses, should include losses suffered on the disposition of: securities; real property, except for residential property as already defined; machinery and equipment used in a business; intangible property as defined in Classes 13 and 14 of the capital cost allowance regulations (as expanded); purchased goodwill; interests in trusts, non-registered pension plans, etc.; and such other kinds of property as could be specifically defined and were not generally employed in personal use. Other property losses would not be deductible from other income, but would be deductible from gains realized on the disposition of similar kinds of property in the preceding two years, in the same year, or in succeeding years. The word "securities", in this context, would mean capital stock and obligations such as bonds, debentures, notes, mortgages, and other funded indebtedness.

To include in the tax base all gains other than those specifically excluded, and to deny a deduction from the tax base of all losses other than those specifically allowed, has obvious advantages in certainty and administrative feasibility. However, it does not explicitly permit all losses that

are not of a personal consumption nature, and therefore we suggest it only as an alternative.

Determination of When a Loss Should be Deductible. In the above discussion the word "loss" has been employed, and the precise meaning of the word therefore becomes significant. Basically, a loss should be defined to occur when there has been a disposition of property at a price that is less than the cost basis, when the property has ceased to have any significant value, or when the value of the property is shown to have declined to a point from which there would be no further fluctuation in value 12/. Although a definition of this nature would permit the claiming of a loss when a disposition had not taken place, ordinarily it would be difficult to do so.

In order to serve as an incentive to risk taking, and to reduce the need for regulations to prevent abuses in this area, we wish to provide additional means of claiming losses. We suggest that a taxpayer should be permitted to value all of his publicly traded securities, or any of them he may select, at either cost or market (or possibly at a price between cost and market). Although the option of valuing securities at a price other than cost would primarily be utilized by taxpayers who wished to claim a loss, in some cases a taxpayer might find it appropriate to accrue an unrealized gain. In this case the taxpayer would compute his income as if he had sold the securities at the year end at the adjusted price, and had reacquired them at the same price. However, in the case of a reduction in market below cost, if later the price of the security recovers, the taxpayer's cost basis should be increased up to the market value but not to an amount exceeding the original cost basis to bring such increase into income. The fact that the taxpayer could use this option for only some of his securities, and need not claim the full write-down to market, should reduce the number of instances when this upward revaluation would be required. This proposal would also considerably reduce the use of the so-called "wash sale" 13/ procedure to recognize a loss or gain, and would therefore avoid some artificial stock market transactions and

fluctuations. However, if the required upward revaluation on a subsequent recovery of prices encouraged taxpayers to engage in "wash sales", consideration should be given to dropping the required revaluation. Experience in the United States has shown that regulations to prevent this type of artificial realization only lead to more complex manipulations.

We also suggest that taxpayers should be allowed to revalue their holdings in a private corporation by following certain procedures. We think that such revaluations should be settled with the tax authorities and that the private companies concerned, rather than individual shareholders, should be responsible for the negotiations. They should be permitted to undertake such negotiations only if formally instructed to do so by the holders of a majority of the voting shares of the company. Individual shareholders would not be required to utilize the valuation so arrived at, but if they did, the tax authorities would retain the right to revalue to not more than original cost if the securities concerned subsequently appreciated in value. This procedure would make investment in risk enterprise more attractive and should reduce the attraction of trading in loss companies. It might become necessary, because of the difficulties of supporting a revaluation of a private share, to introduce regulations permitting the use of stated valuation procedures. In any event, we hope that the tax authorities would establish the procedures to be followed in a manner that would minimize uncertainty for the taxpayers concerned.

Individual taxpayers might also be permitted to revalue other property that was not employed in a business, if they were able to demonstrate that there had been a loss in value. Again, upward revaluation should be required in the event that the property regained its value. Thus, an individual could be permitted to revalue an interest in a trust or a similar intangible property interest. This provision should not be extended to property employed in a business, because the ordinary rules applicable to the determination of property losses in a business, and the amortization of depreciable property

should be satisfactory. In any case, a loss suffered by a company could be claimed by a shareholder through the disposition or revaluation of his shares.

Dispositions for Tax Purposes

The principle of recognizing only realized gains on property may generally be accepted on grounds of administrative convenience, but the principle of taxpayer equity would be violated if it were possible for taxpayers to postpone indefinitely, or to escape permanently, their underlying tax liability. The comprehensive tax base that we recommend includes all a taxpayer's increments in wealth, whether realized or not. Any variation from the procedure of computing tax liability on the basis of an annual accrual of property increments would be a violation of equity, even though administrative considerations may make such a variation necessary.

It would be possible to accept the postponement of taxes inherent in the realization principle only if it were temporary. We have therefore said that the term "disposition" should be used in the broadest sense. It should include any form of transfer or alienation of title to property, including sales, exchanges, gifts and bequests of property, except transfers from one member of a family unit to another. It should include the termination of a contingent interest in property, and extend to involuntary disposals of property arising, for example, through expropriation, theft, damage or destruction; in such cases any compensation recovered whether by insurance, damages or otherwise should be treated as proceeds of disposition. While in the case of bona fide transactions at arm's length the actual proceeds should be included in computing income, in the case of gifts, bequests and transactions not at arm's length, the disposition should be deemed to take place at the fair market value. However, we suggest that, under certain circumstances discussed below, some of these involuntary disposals should not be regarded as dispositions for tax purposes.

Exchanges of Property. The exchange of one property for another could raise difficulties, because the parties would not realize cash with which to pay any tax liability that may accrue. In the case of voluntary dispositions there generally should be little hardship because the parties would supposedly have foreseen the situation and have taken steps to meet their tax liabilities. Because an individual taxpayer would be required to pay tax on his accrued gains at the latest upon his death or that of his spouse, the hardships would be mainly a question of timing, because an exchange would attract tax at an earlier date than would otherwise have been the case. To exempt voluntary exchanges of property for the corporation would be especially unreasonable, for it could result in a permanent deferment of tax liability. However, certain specified types of exchanges, especially those occurring in connection with certain corporate reorganizations, should not constitute realizations. These are discussed below.

Disposition on Death. We do not suggest that a transfer on death should be excluded from being a disposition for tax purposes. Although the United States does make such an exclusion, and although the United Kingdom has a substantial monetary exclusion, we consider that it would be a serious breach of taxpayer equity to grant such an exclusion from the comprehensive tax base. For example, one could compare the lifetime tax burden of two taxpayers with identical lifetime economic incomes, on the assumptions that one taxpayer died the day after liquidating all his assets, while the second taxpayer died before any such liquidation. The tax capacity of the two taxpayers would be identical, but their tax liabilities could be drastically different, and would be equalized only if there were a deemed disposition for tax purposes on the death of the second taxpayer. The economic implications of deemed dispositions in such cases are also considerable for, as has already been discussed, to the extent that immobility of capital investment does exist in the United States, it would appear to be largely the result of the tax deferment and exemption extended to accrued gains on property transferred by gifts and bequests. Basically, we consider it would be intolerable

to permit some taxpayers to escape their "accrued" tax liability by merely reducing the number of dispositions that they made during their lifetime.

There are two potential inequities that could result from the taxation of a disposition on death. The first concerns the availability of cash to meet the tax liability. The second results from the possible application at one time of steeply progressive rates of tax to an amount of income that had accrued over a number of years. We feel that taxpayers are capable of planning their affairs to meet the first situation, but that payment of certain tax liabilities should be permitted over time with an appropriate rate of interest. The problem would be substantially alleviated by our recommendation that under the family unit approach there should not be a disposition for tax purposes on the death of one spouse, but only when the family unit terminated. The averaging provisions we recommend in Chapter 13 should be adequate to relieve most problems resulting from the bunching of income.

Excluded Transactions. In addition to recommending that there should be no disposition for tax purposes on a transfer between members of a family unit, there are other cases in which we recommend that a disposal should not be considered to have taken place. Transactions of this nature should be specifically excluded from being dispositions for tax purposes. Generally these are cases where there has been no change in the essential continuity of an investment, although there may have been some alteration in the form of the investment.

In the event of certain involuntary disposals of business property, any proceeds received may be required to be reinvested in replacement property to ensure continuity of the business. The present legislation with regard to the recapture of depreciation recognizes this situation, by providing that insurance proceeds payable in respect of loss or destruction of property need not be brought into income if reinvested in similar property within a limited period. We recommend that such a provision should be retained and extended to apply to gains in excess of the cost basis. It should also

cover damages or other compensation for loss or destruction of property, and the proceeds resulting from an actual or threatened expropriation or compulsory taking of property, but only to the extent that the proceeds are reinvested in property of a similar nature within a reasonable period. In such cases, the cost basis of the new property would be related to the cost basis of the original property.

It is also necessary to consider the extent to which corporate reorganizations, amalgamations and other inter-company transactions should attract tax. We recognize that it is often necessary to change the form of ownership of a business or property, or to rearrange or reorganize the affairs of corporations for business reasons. If every such change or reorganization were to result in a disposition for tax purposes by the shareholders, or the corporation, or both, this could have an inhibiting effect and could tend to produce undesirable rigidity in corporate structures. Because we regard a corporation as an intermediary, and individuals as the persons who ultimately bear the taxes, we consider that certain corporate reorganizations and transfers which change the form of ownership, but do not effect a change in the ultimate beneficial ownership of a business or property, should not result in a tax liability.

A type of transaction which does not involve a change in the essential continuity of an investment can occur when a business is incorporated. Accordingly, where property other than securities is transferred by an individual or individuals to a new company in exchange for common shares of the company, we consider that the disposition of each asset or class of assets should generally be regarded as having taken place at its cost basis to the transferors as adjusted by capital cost allowances and otherwise to the date of transfer (which is referred to below as the adjusted cost basis). However, the parties should also have the right to elect that the disposition would take place at a price which was specified as being the fair market value of the assets transferred. If this election was made, and if the price specified

for all the property transferred and for each asset or class of assets should be shown not to be the fair market value, the administration would be entitled to require that this price be adjusted to the fair market value.

In the event that the property was transferred by an individual to a new company in exchange for common shares of the company which were publicly traded and which represented less than, say, a 25 per cent interest in the outstanding common shares of the company, the disposition should not be permitted to take place at the adjusted cost basis of the property to the transferor, but rather should be at the fair market value of the property transferred. Otherwise, an individual selling property to the company would be able to unduly defer taxation on the profit realized on the exchange. If the transfer was made at the cost basis of the property rather than the fair market value in consideration for common shares which were not publicly traded, or which were publicly traded but represented more than 25 per cent of the outstanding common shares of the company, and these shares subsequently became publicly traded or became less than 25 per cent of the outstanding common shares of the company, the individual should be deemed at that time to have disposed of the shares at their fair market value and to have reacquired them at the same price.

The procedure outlined above for the transfer of property to a new company should apply equally to a transfer of assets to an existing company in exchange for common shares by the individual who owned all of its common shares, or by several individuals who owned all the common shares if the transfer was made by the individuals in proportion to their shareholdings and this proportion did not change on the carrying out of the transaction.

It may be that the procedures we suggest could be made available where the property was exchanged for redeemable preference shares or other securities, as well as when it was exchanged for common shares, but it would be necessary to regulate such a procedure to ensure that it was not utilized as a device for tax deferment.

Another type of transaction which does not involve any change in the continuity of investment is a transfer between a company and its wholly owned subsidiary or sub-subsidiary, or between companies which are wholly owned directly or indirectly by the same shareholder (or by the same shareholders in the same proportions). This would include a liquidation of a wholly owned subsidiary corporation. The legislation should provide that any such transfer of an asset or class of assets may be made at its adjusted cost basis to the transferor, or at the fair market value, or at any price between these two figures. In the case of each such transfer, including a transfer on a liquidation of a wholly owned subsidiary, the transfer price, or the basis of computing the transfer price should be specified by the parties. If it was lower than both the cost basis to the transferor and the fair market value, or if it was higher than both of these amounts, the administration should be entitled to require that the price should be adjusted accordingly.

We must also consider the treatment of a statutory amalgamation of two or more companies. In this case there should not be a deemed disposition of the assets of the companies, but there should be a deemed disposition by the shareholders (except an amalgamating company) of their shares at the fair market value. The same treatment should apply if a corporation transferred all its assets to another corporation in consideration for securities of the other, provided the transferor corporation was then liquidated immediately. In this case, as on any liquidation, the shareholders of the transferor corporation would be regarded as having disposed of their shares for a consideration equal to the value of what they received on the liquidation. This value would then be the cost basis of the securities received on the liquidation. The cost basis of the assets to the transferor company, and the tax treatment of the assets transferred, would be carried over to the continuing corporation. This would also apply in the case of an amalgamation. The provisions contained in section 85I of the Income Tax Act could be used as a guide in this connection.

As far as other corporate transactions are concerned, our general approach is that transfers and exchanges of assets and securities in such cases should constitute dispositions for tax purposes. However, while it may be reasonable to tax share exchanges of capital stock in two unrelated corporations, primarily to ensure tax neutrality between the various forms of purchase offers, and because of the complexity and tax avoidance that could arise if any exemption were permitted, exchanges of capital stock in the same or related corporations are in many cases a reasonable subject for exemption. The interest of the shareholder may not be materially altered in substance, although it may be in form. It is possible to define a restricted exemption in this case in a manner that should preclude most uncertainty and most possibilities of utilizing the exclusion as a tax postponement device. We suggest that an exchange of shares of capital stock should not be a disposition if immediately after the exchange the taxpayer had the same proportionate participation in votes, in distribution of income and on liquidation that he had immediately prior to the exchange. This rule should apply to the subdivision or consolidation of the shares of a company, to the splitting of shares of a particular class into two or more classes of shares, to the variation of some rights attaching to shares, and to similar kinds of recapitalizations. The cost basis of the securities exchanged should apply to the new securities received. We do not suggest any other exemption on an exchange of securities, although we do not rule out the possibility that others could be developed that would not invite exploitation for tax avoidance purposes.

The disposition of an asset by way of security for an obligation should not be treated as a disposition for tax purposes. The same rule should apply to the re-transfer of the asset on the discharge of the obligation. Although a taxpayer could in this manner obtain cash in excess of the cost basis of property without any tax liability, we feel that it would be exceedingly difficult to enforce any provision that deemed a loan on a security to be a disposition for tax purposes.

The United States Internal Revenue Code contains various provisions which allow a tax deferment for certain kinds of corporate reorganizations and share exchanges. These provisions, by and large, are complex and have led to problems of tax avoidance. Apart from this, certain of the reorganizations permitted in the United States would not be feasible in Canada because of differences between the corporate laws of the two countries. We have also considered the fact that the United Kingdom provisions in this general area, including those relating to take-over bids, are more liberal than those we have suggested. These provisions are also somewhat complex, and it is not yet clear how they will work in practice.

Our general approach is partly influenced by our proposal for the integration of the corporate and the individual tax, a procedure that is not now followed by either the United States or the United Kingdom. We think that under our integration proposals, capital gains on shares arising from an accumulation of underlying corporate earnings would not be the problem that they would be if integration were not introduced. We also think that a tax-free investment roll-over would in most cases lead to more inequities than it would alleviate. Although problems of liquidity could arise under our approach because the shareholder might not have the cash available with which to pay the tax, we do not believe that this problem would be sufficiently serious to warrant introducing complex measures that could lead to uncertainty and to tax avoidance. Moreover, reorganizations often take place in times of corporate difficulty when it is unlikely that a gain would result. This may not ordinarily be the case where corporate amalgamations or take-overs are involved, but in these circumstances there is usually a material change in corporate structure or control, and the gain involved is to a large extent the result of such change. In such circumstances it appears reasonable to impose the tax at the time the gain arises.

We appreciate that our list of exempt dispositions is limited and perhaps should be extended. We think, however, that additions should be made

only after careful consideration of the problems of administrative complexity, uncertainty, and possibilities for tax avoidance which may be involved.

Deemed Disposition on Change of Residence. Apart from the cases of voluntary or involuntary dispositions already mentioned, we recommend that a disposition should be deemed to have occurred when a taxpayer, individual or corporate, gives up Canadian residence.

The same equity considerations already discussed in connection with a disposition on death apply to the question of deeming a disposition to have taken place when a taxpayer gives up his Canadian residence. We do not think it should be possible for a taxpayer to escape tax on property gains that have accrued during his residence in Canada simply by becoming resident in another country. Our recommendations for general averaging provisions, and for spreading the payments on the tax liability should be sufficient to meet the major difficulties of liquidity and lump sum income that could arise.

The deemed disposition on a change of residence would also be significant for a taxpayer who became resident in Canada. Because the disposition would be deemed to take place immediately prior to the change in residence, such a taxpayer would value all his property at market value when he became resident, and would be subject to tax only on subsequent gains.

There are administrative problems in connection with deemed dispositions on a change of residence. We recommend that in general individuals leaving Canada should either be asked if they are giving up their Canadian resident status or should be required to sign a simple declaration indicating whether they are emigrating or only planning a temporary absence. Those who were emigrating should be required to show evidence

of a tax clearance, which would be obtainable only after the filing of a final tax return that brought accrued property gains into taxable income. It would be essential to have procedures under which clearance for emigration would be issued expeditiously on the posting of adequate security or on the giving of adequate undertakings without awaiting assessment of the final return. Also, if suitable arrangements to ensure payment of future tax liabilities could be made, the taxpayer should be permitted to elect to continue to be taxed as a Canadian resident by filing returns on a world income basis, so that a disposition would not have to be deemed to have occurred.

We appreciate that at the present time questions are only asked of, or forms required from, persons entering the country, so that additional staff would be required to implement this recommendation. However, to accomplish the desired objective the procedures would not have to be complex. Initially the question need only be asked and a form required from those who indicate they are giving up their resident status. In some cases (e.g., commuter crossing points) it would not even be necessary to ask any questions. Eventually the carriers (airline, railway or bus line) might be asked to have their passengers complete a simple form which the carrier would then turn over to the border official.

The enforceability of provisions such as these would to a great extent be dependent upon taxpayer honesty, which fortunately has been sufficient in Canada for the operation of a self-assessment system. Most taxpayers would be unwilling to sign a false declaration and, more important, would be reluctant to be labelled as tax evaders who could not re-enter the country because of the threat of prosecution. The tax authorities would have no difficulty in determining who had not made an accurate declaration, for the fact that annual tax returns ceased to be filed would raise questions as to why the taxpayer was not reporting his

income. Although it would be necessary, in order to maintain the equity of the tax system, that action should be taken to collect tax at the time of a change of residence, we have not recommended more stringent procedures because it is also important that regular business activity and ordinary travel should not be inhibited or restricted. It may be that some individuals would avoid their liability, but under our suggested procedure it would be clear in such cases that an illegal act had taken place.

Assuming that the present basic rule remains that companies incorporated in Canada shall be deemed resident here, we are concerned simply with companies formed abroad which have become resident in Canada and then cease to be so resident. The number of such corporations is likely to be small, but we think it appropriate that a disposition of their assets should be deemed to take place for Canadian tax purposes when they ceased to be resident here. Enforcement measures where necessary could be directed against the individuals who were directors or officers at the time of the change of residence.

Because it would be possible that a taxpayer, after a change of residence, might also become subject to tax in another jurisdiction when the accrued gain was realized, it would be necessary to allow a full foreign tax credit with respect to such gains, even if this involved a refund at a later date when the foreign tax was paid.

<u>Accrual of Gains or Losses</u>. The final question we wish to discuss in the context of dispositions is whether there should be at least a modified form of taxation of property gains on an accrual basis. We have emphasized in a number of places in this <u>Report</u> that income arises when there is an increase in economic power, and that economic power increases when the market value of property increases. We have also pointed out

the inequity inherent in the realization approach, in that taxpayers who retain investments which have appreciated in value are, in effect, allowed a tax-free investment of the accumulated gains that are built up free of tax, while others, who turn over their investments, are denied this privilege. Nevertheless, we have suggested that other considerations, for example, the administrative difficulties involved, require that, in general, the theoretically correct accrual approach must give way to a realization basis for determining income.

On the other hand, in a number of places in this chapter we have pointed out cases where the realization basis in itself would lead to administrative difficulties and inequities. Most important, we have emphasized that under the comprehensive tax base, which would require that all income would be taxed at full progressive rates, there could be some reduction in the mobility of capital if property gains were taxed on a realized basis only. An accrual approach would also assist in reducing the problems associated with deemed dispositions, corporate reorganizations, and other situations where the build-up of gains over a number of years created difficulties, not only because of the liquidity problems, but because the large potential tax liability would increase the risk of attempts at tax evasion. Also, any reduction in the volume of untaxed accrued gains would lessen the significance of the arbitrary rules for determining when a disposition had taken place.

If the accrual requirement was made applicable only to assets that could be readily valued and was not required annually, then difficult administrative problems should not arise. In particular, because the number of securities involved for most taxpayers would not be large, it would be a relatively simple matter to value publicly traded securities every five years. Such a procedure would be applied to each holding of a publicly traded security once it had been retained for five years. This

would mean that the accrual requirement would be applicable only in a limited area, but would have the desired effect of reducing substantially the long-term accumulation of untaxed gains.

We have considered the problem of the ability of the taxpayers to meet such tax liabilities, and have concluded that even if a taxpayer were forced to liquidate some part of his holdings it would not generally lead to hardship, but rather would be a necessity for overall taxpayer equity in order to ensure that taxpayers were not allowed to defer payment of their income taxes. It is unlikely that many investors would experience any difficulty in meeting such tax liabilities, particularly because our integration proposal should increase the total cash flow to most shareholders, but hardship could arise where there was a thin market for the securities. Therefore, if some consideration were to be given to the liquidity problem it should be in the form of allowing a time period for the payment of taxes on accrued gains that exceeded a certain proportion of total income. Interest should be payable on such deferred taxes.

After some experience had been gained and after certain valuation procedures had become more widely accepted, it seems likely that such a requirement for periodic accruals could be extended to other forms of property. For private companies, the use of the same valuation procedures as those employed for the optional revaluations we have suggested earlier would appear to remove undue difficulties. In fact, after some experience had been gained in this area, it should be possible to formulate a number of rules that would greatly facilitate the valuation process.

Nevertheless, despite our concern with the inequity, complexity, and the other problems of the realization approach, we do not recommend the immediate enactment of provisions taxing accrued gains.

Computation of Gain or Loss

When a disposition for tax purposes took place, it would be necessary to determine the amount of the resultant gain or loss. In most cases the computation would be relatively simple, with the cost basis of the property being deducted from the net proceeds on disposition. The net proceeds would be the balance of the consideration for the property that remained after all the expenses of disposing of the property had been deducted. In the case of non-cash gifts, or deemed dispositions on death or change of residence, the proceeds would be based on the fair market value of the property. The cost basis would include all acquisitions and improvements and certain other adjustments that we have already discussed.

The receipt of stock dividends, or other forms of non-cash distributions or allocations on shares which we describe in Chapter 19, would increase the cost basis. Similarly, the attribution or allocation for tax purposes by an intermediary of a property interest, such as a share in a trust or an interest in an unregistered pension plan, would increase the cost basis of the property interest. If the holders of securities of a company were issued rights to take up additional securities, the cost basis of their original holdings would be increased by the amounts paid to exercise the rights. In addition, we have suggested that a taxpayer should be permitted to add to the cost basis of property, other than property of a personal expenditure nature, certain expenditures attributable to the holding of the property.

A partial disposition of property would involve a reduction in the cost basis. In determining the cost basis when only a portion of the holding was disposed of, either a first-in-first-out or an average cost basis would appear to be reasonable for identifiable interchangeable

pieces of property. In instances where only a portion of a particular property was disposed of a reasonable allocation of cost would be acceptable.

Administration

To bring property gains and losses into account for tax purposes should not unduly increase the administrative difficulties of the tax system and, in fact, for reasons already given, should substantially ease administration in the long run. However, because enforcement of the law primarily rests upon taxpayer compliance, an annual reporting of holdings of securities and real property should be required. Although such a listing is not required in the United States or the United Kindgom, it would greatly assist the tax authorities in their verification procedures, and would enable the taxpayer to maintain an adequate and up-to-date record of the cost basis of his investments. We have reviewed information supplied by the Department of National Revenue and have concluded that the number of items of property to be listed would not be large except for much less than 1 per cent of taxpayers.

The tax return should include a space for a declaration by the taxpayer that he did not own at any time during the year, directly or indirectly, a beneficial interest in any securities or real property. If this declaration were not completed, the taxpayer should be required to furnish a schedule listing the following: his holdings and their cost basis at the beginning of the year; acquisitions, dispositions, and any other changes in the cost basis during the year; and the cost basis of holdings at the end of the year. In addition, the gain or loss on disposition and other property income received would be listed and totalled to provide the necessary income figures. The return should also include a question as to whether any other forms of

property were sold during the year at a price in excess of cost, and whether certain types of property were disposed of during the year at a price less than cost. An affirmative answer to this question would necessitate the provision of particulars which would establish the gain or loss.

Transitional Provisions

To include property gains and losses in the tax base would raise a number of problems which, although initially significant, would gradually fade in importance. We think that those problems, even at the outset, would be eased by the transitional provisions we propose.

We do not intend, of course, that the taxation of property gains should be retroactive. Where gains on the disposition of property held at the effective date of the legislation would be tax free under the present law, the gains accrued to that date should continue to be free of tax. Gains ultimately realized on the disposition of such property should be taxed only to the extent that the proceeds of disposition exceeded fair market value at the effective date as revised by any subsequent adjustments to the cost basis.

Property included in the inventory of a business is subject to tax on disposition under the present law. Accordingly, there would be no need to revalue such property at the effective date of the legislation. This would also apply in the case of property which was held for disposal as part of an adventure or concern in the nature of trade. Because a profit or loss realized on the disposition of such property is taken into account in computing income under the present law, its value at the effective date would have no significance. The principal type of property in this category is probably land, because under the present law and Department of National Revenue practice, securities are normally regarded as investments unless held by a security dealer. We recommend that where there is doubt as to whether the disposal of an asset would result in taxable income under the present law, the tax authorities should be willing to give a ruling on this

point to assist the taxpayer in deciding whether a valuation would be necessary. We also recommend that in order to ease the problems of transition, the tax authorities should adopt a liberal approach in giving such rulings. If a taxpayer received an adverse ruling on this question he would, of course, be entitled to obtain a valuation of the property at the effective date and, when he disposed of the property, to have its status under the present law determined by the courts.

Because capital cost allowances are subject to recapture under the present law, such allowances which had been deducted before the effective date should continue to be subject to recapture. However, if at the effective date depreciable property had a value in excess of its original capital cost, this excess should not be taxable in the event of a subsequent disposition. If such property were sold following the effective date, the undepreciated capital cost of property in the class would be adjusted as under the present law, and if the present law would result in recapture of depreciation, this would be taxable. In addition, if the sale price exceeded the capital cost, this excess would be taxable only to the extent that the sale price exceeded the value of the property at the effective date or the capital cost of the property, whichever was greater. This treatment should result in complicated calculations in only a few cases, because depreciable property would not ordinarily have a value in excess of its capital cost. Valuation of such property at the effective date would be necessary only where the value was likely to exceed capital cost and when the taxpayer did not wish to utilize the optional procedure described below.

The major property owned by most taxpayers is residential real estate, but the $25,000 exemption we recommend for gains on such property should mean that few home owners would be concerned with a potential tax liability on this type of property. In any case, the alternative to a detailed valuation described below should be acceptable for most home owners who were uncertain as to whether they would be exempt from tax under the prescribed dollar

exemption. Publicly traded securities are held relatively widely but, because of their marketability, there would be little difficulty in determining their values at the effective date. Non-residential real estate would pose some valuation problems, although appraisals would not be difficult to obtain in most instances. The major area of uncertainty as regards valuations would be unincorporated businesses and private companies. Valuations of these types of property are usually made only at the time of sale, or when a gift or estate tax valuation is required. However, an alternative is suggested below which should be more attractive to most taxpayers than a detailed valuation.

To ease the difficulties that could arise in establishing fair market values at the effective date, it is suggested that the taxpayer should be given the option, except as regards publicly traded securities, of either obtaining departmental approval of a detailed valuation of some of his property as at the effective date in a manner similar to an estate tax valuation, or of computing an arbitrary value when the property has been ultimately disposed of based upon the following procedure. The difference between the net proceeds of disposition and the cost basis of the property, that is, the original cost of the property, regardless of when it was acquired, plus additions and less disposals, would be apportioned over the total time the property had been held or was deemed to have been held. For this purpose it should be assumed that the period of time that the property had been held prior to the effective date would be the lesser of the actual time held or, say, ten years. An arbitrary limit on this aspect of the computation should eliminate most of the difficulties of determining exactly when property was acquired. It would also reduce the unfavourable effect on equity and mobility that such a transitional provision would otherwise have, because of the potential tax exemption for gains accruing after the effective date on property that had been held for a substantial period of time. In the case of net gains, the portion attributable to the period subsequent to the effective date would be reduced by an arbitrary percentage, say, 25 per cent,

while in the case of net losses this portion would not be adjusted. These balances would then be brought into the computation of income for tax purposes.

We expect that this simple and liberal procedure would discourage detailed valuations. Its adoption would be encouraged by limiting to two years the period during which the taxpayer could elect to make a detailed valuation, and by stipulating that if approval of a detailed valuation were requested, the right to elect the arbitrary procedure would be lost. If the taxpayer and the tax authorities were unable to agree on the detailed valuation, either should have the right to refer the matter to the court. It should also be provided that the same guidelines accepted for a detailed valuation would be applied to any later valuations of the same item of property. Thus, the taxpayer who obtained an unduly high detailed valuation at the transitional date would find that the same basis would be used by the tax authorities at a later date when there was a gift or bequest.

In respect of publicly traded securities a taxpayer might be permitted, in the case of a gain, to employ as his cost basis the higher of the original cost or the actual valuation. If implemented, this procedure should only be available where the property was disposed of within a limited period of three to five years. In the case of a loss, the actual valuation would be employed. This would exempt from tax those gains that represented a recovery of a loss that had accrued prior to the effective date of the legislation.

The adjustments to the cost basis of capital stock necessitated by distributions from undistributed income on hand at the effective date are discussed in Chapter 19. The cost basis of proprietorships and partnerships which were on a cash basis as at the effective date would have to be reduced from market value by the amount of any adjustment resulting from the conversion of the accounts from a cash to an accrual basis. Because the valuation of corporate shares would take into account the market value of the underlying assets, including goodwill, the valuation of these assets would

have to be adjusted to reflect the market value of the shares in order to ensure a proper computation of subsequent gains or losses on any disposition of the underlying assets.

The tax authorities would have to provide for a substantial temporary increase in staff. If a number of special officers (with specialized training in the valuation of companies and real property) were appointed to assist the proposed new Tax Court, disputes should be settled equitably and fairly rapidly.

INCOME FROM HOLDING PROPERTY

Interest

There are no major problems in connection with the inclusion in income of interest received. However, some minor difficulties arise in determining the time of receipt.

In general, the rules of constructive receipt are interpreted to bring an amount into income when it is made available to a person unconditionally, so that it could have been received in cash or its equivalent. However, under present practice there is a general exception to this rule in the case of matured bond coupons, which are usually not included until they are cashed. In the United Kingdom this same procedure is followed, while in the United States the courts have applied the doctrine of constructive receipt to include uncashed matured coupons in income. We recommend that such coupons should be treated as income when they become due, subject to a deduction for bad debts, even if they were not cashed.

A similar problem concerns interest accrued by the borrower, but not payable to the investor until some future time. An example is an investment certificate which provides for the retention and reinvestment of the annual interest until a future date. Generally, under present practice, the tax liability does not arise until such interest is received by the investor in cash.

We are not in favour of attaching such importance to the form of a transaction when, in substance, the investor enjoys the benefits of the interest through reinvestment, once it has been credited to him. In our opinion, amounts credited directly or indirectly to the account of the taxpayer, or held on his behalf, should be regarded as realized by him, whether or not he was entitled to receive possession. Therefore, we recommend that all taxpayers be required to report interest income when it has been credited directly or indirectly to them. For administrative convenience, the inclusion of amounts less than $10 in the case of each taxpayer should not be required. In addition, a taxpayer who was not in the business of lending money should be permitted the option of excluding from income interest that, in the usual course of events, would be received in cash in the subsequent taxation year, because little postponement would be involved and it would be simpler to record such income on a cash basis. Non-collectible interest which had been reported as income would be deductible as a bad debt, and if payment is doubtful, the taxpayer should be entitled to a reserve.

In the case of an amount that was made up of blended principal and interest, for example, payments under a mortgage, the payee should be required to make a reasonable allocation. If he did not do so, the tax authorities should have a right to allocate under a provision similar to section 7(1) of the present Act.

We recommend that the reporting requirements for payors of interest should be altered to apply to interest credited directly or indirectly to the benefit of the investor, as well as to interest paid. If a payor of interest which is deductible was either unable or unwilling to credit interest to the ultimate beneficiary, a withholding tax of 50 per cent should be collected and held by the government until such time as the interest was paid or credited to the payee.

One difficulty in the taxation of interest has been that taxpayers do not always report interest paid as they are required to do. It is difficult

to enforce this requirement, because in many instances taxpayers who pay interest do so on their personal account and are not entitled to a deduction. Thus, recipients of interest know that it is virtually impossible for the Department of National Revenue to trace interest, and sometimes fail to report it.

The personal tax return should be expanded to require a taxpayer to report both the amount of all interest, or interest and principal, paid in the year and the name of the recipient. This would serve as a cross-check and would to a very large degree cut down avoidance through non-declaration.

We have reviewed the question of withholding tax at source on payments of interest. In the case of individuals paying interest, we think that a withholding requirement would be an idle one. Such a law would be completely unenforceable and we do not recommend it.

On the other hand, it seems reasonable to require financial institutions to withhold at source and remit tax on interest paid and accrued. Institutions of this nature possess the necessary accounting records and procedures. Also, the various governments and corporate borrowers should withhold tax when paying interest on their obligations. Therefore, we recommend that all corporations, governments and government organizations be required to withhold tax at a rate of 15 per cent on all interest paid or credited. This requirement should also apply to bearer bonds, but should pose no difficulty, because the coupon would be redeemed at its face value less the amount of the tax.

Where interest was paid to a tax-exempt entity, there would be little value in withholding tax. Therefore, we recommend that a tax-exempt entity, as opposed to a person who is non-taxable because of low income, should be entitled to apply to the tax authorities for an exemption certificate which when delivered to the payor would relieve him of the obligation to withhold. This provision could apply equally to non-resident and resident tax-exempt entities.

The problems currently arising because of the difficulty of determining whether discounts or premiums are taxable would be eliminated by the full taxation of all gains or losses on securities. The amortization procedure should follow accepted practice.

Dividends

The taxation of dividends is discussed in Chapter 19, where the wider use of reporting forms and the question of withholding at source are considered.

Royalties

The present legislation is inconsistent, in that amounts received "that were dependent upon use of or production from" property are included in income under section 6(1)(j) of the Act, while the outright sale of a property right may yield a tax-free gain. This anomaly would be taken care of by our all-inclusive concept of income. The problem of "bunched" income that might otherwise result would be met by the averaging provisions detailed elsewhere in this Report. If it were felt that some special consideration should be given to the proceeds of sale of a patent or copyright, such proceeds might be made eligible for a special averaging provision. However, we do not believe that such a provision would be necessary.

Rental Income

Rent should be included in income and the recipient required to pay tax on it in the same way as at present. Premiums for the granting or cancellation of leases would be income to the recipient and deductible to the payor, except where they were a personal expense, as part of the comprehensive tax base. There are cases, however, when it would be difficult to determine whether an amount was rent, which is basically a payment for the use of property for a term certain, or whether it was a payment on account of the purchase price. In a lease-option arrangement the lessee ordinarily has a right to lease a property and then to purchase it at a specified price. It

can be argued that the "rental" payments are really payments on account of the purchase price. The subject of lease options is dealt with in Chapter 22.

The personal tax return should be expanded to require a taxpayer to report both the amount of all payments of rent in the year and the name of the recipient. This would serve as a cross-check, and to a large degree cut down avoidance problems caused by non-declaration.

Deductions from Property Income

We make the general recommendation that all expenses reasonably related to the earning of income should be deductible in computing that income. We have concluded that allowances of an arbitrary nature such as percentage depletion allowances should be replaced by the write-off of actual expenses, or at least should be restricted to amounts that are a reasonable approximation of the actual expense. Also, we recommend that special incentives should be examined to determine whether they are effective or whether a direct form of subsidy would be more effective. These general observations should also apply to the expenses of earning property income.

At the present time, taxpayers may deduct half the fees paid to an investment counsel and all interest paid on funds borrowed to gain or produce taxable income 14/. The latter allowance, in effect, has permitted the deduction of interest from personal dividend income, even though ownership of the security may also have resulted in tax-free gains. Because all property income, including gains, would be taxable under our proposals, investment counsel fees should be deductible in full. In effect, commissions and transfer taxes would also become deductible, because they either reduce the gross sale price or increase the cost basis.

The requirement that interest, to be deductible, must be paid on funds specifically borrowed to gain income has led to some apparent anomalies, because individuals paying mortgage and similar interest, and who also have property income, have not been able to claim such interest as a deduction

unless they could specifically relate the borrowing of the money to the earning of income. We do not recommend that all interest should be deductible regardless of the purpose for which the funds were borrowed, because this would in many cases amount to the allowance of an expenditure of a personal consumption nature. However, the suggested general provision, that expenditures should be deductible where they are reasonably related to the earning of income, should reduce the problem created by the disallowance of interest in some circumstances.

At the present time the Act permits a deduction of a depletion allowance by the shareholders of certain companies 15/. Under our proposals these companies would be permitted to write off in full their capital investment; dividends paid out of capital (if permitted by law) would not in themselves be subject to tax, and any losses in capital reflected in the prices of the shares would be deductible. There does not appear to remain any reasonable justification for the continuation of this measure, either as an expense allowance or as compensation for loss of capital. As an incentive measure, the provision is a form of industry favouritism that does not appear to be warranted. Therefore, we recommend in Chapter 23 that the shareholder's depletion allowance be withdrawn.

Investment Income Surtax

The present legislation levies a special tax of 4 per cent on the total of the taxpayer's investment income "from sources outside Canada" in excess of the greater of $2,400 or the aggregate of the taxpayer's personal deductions 16/. Until 1961 this surtax applied to all investment income, but apparently it gave rise to objections that it was an inequitable burden on many retired taxpayers. In that year its application was limited to income from foreign investments, partially in an attempt to remove any discouragement of investment by Canadians in Canadian securities. We suggest that such a "disincentive" to foreign investments is more punitive than effective, and that in any case our proposals for integration of corporate and

personal taxes are a much more potent incentive to Canadians in this regard. Therefore, we recommend that this surtax should be abolished.

CONCLUSIONS AND RECOMMENDATIONS

TAXATION OF GAINS AND LOSSES

1. All realized gains on the disposition of property, with the exceptions noted in Recommendations 8 to 14 below, should be included in full in income and taxed at full progressive rates, subject to the averaging provisions we recommend in Chapter 13. Residents should be taxed on world gains; non-residents only on gains attributable to permanent establishments in Canada.

2. All losses on the disposition of property, other than those arising on the disposition of property used for personal consumption, should be deductible in full from any other income and should be eligible for the same carry-over provisions as business losses. Property losses of a personal nature, except those incurred on disposal of a residential property, should be deductible from gains on similar property realized in the preceding two years, in the same year, or in succeeding years.

3. The taxable gain or loss would be determined by deducting the cost basis from the proceeds of disposition. In the case of a bona fide disposition in a transaction at arm's length, the actual proceeds of disposition would be taken into account. In the case of most other dispositions, the proceeds would be deemed to be the fair market value of the property disposed of.

4. Losses incurred on the holding of property should not be deductible from other income, but should be available for carry-back two years and forward indefinitely for deduction from operating income from the same property. A taxpayer should be entitled at his option not

to deduct certain carrying expenses such as interest and municipal taxes but to capitalize them and add them to his cost basis, so that they would be taken into account in computing the ultimate gain or loss on disposition of the property.

5. Taxpayers should be permitted to revalue certain property up or down to market, or possibly to a price between cost and market, and to report the loss or gain as if a disposition had taken place. This value would then become the cost basis. Where there had been a write-down and the market value recovered, it would be necessary to write the property up to market, but not to an amount exceeding the original cost basis. Property qualifying for this treatment would include publicly traded securities, shares of a private company if authorized by the company, interests in trusts, and possibly other assets not used in a business.

DISPOSITIONS

6. A disposition should include all sales, exchanges, transfers, gifts, bequests and losses through theft, damage, or expropriation, except for certain specifically excluded transactions referred to below. In the case of bona fide arm's length transactions the actual proceeds would be included in income and in the case of other dispositions the fair market value of the property would be deemed to be received. There should be a deemed disposition at the fair market value of a taxpayer's property when he ceased to be resident in Canada, unless he elected to continue to be taxed as a Canadian resident on his world income. There should also be a deemed acquisition on the same basis when a non-resident becomes a Canadian resident.

7. There should be a disposition of a taxpayer's property at the fair market value at death, unless the property passed to a member of the

same family unit. Ordinarily, on a transfer from one member of a family unit to another, no disposition would be considered to occur.

EXCLUDED TRANSACTIONS

8. Gains on residential and farm real property should be excluded from income up to a lifetime total of $25,000. To determine the cost basis of residential property, the original cost should be increased by the cost of actual improvements or, at the option of the taxpayer, by 1 per cent of the cost of the building for each year the property had been held.

9. In the case of an involuntary disposition occurring on a loss or destruction of property, or on an expropriation, to the extent that the proceeds were reinvested in similar property within a stipulated time there should be deemed to be no disposition.

10. Special rules should apply where individuals transfer property other than securities to a company in exchange for common shares, provided the company has been newly formed or was an existing company whose shares were owned by the transferors in the same proportion in which they were transferring the property. Generally, each asset (or class of assets) should be regarded as having been transferred at its cost basis to the transferors, unless the parties elected to transfer it at its fair market value. However, if the common shares received by a transferor were or became publicly traded and represent less than 25 per cent of all the common shares of the company, the transferor should be regarded as having made a realization at the fair market value.

11. Where property is transferred between a company and its wholly owned subsidiary or sub-subsidiary, or between companies wholly owned by the same shareholder (or the same shareholders in the same proportions), the disposition of each asset or class of assets should be

at the cost basis to the transferor, or at the fair market value, or at any price between those amounts which was specified by the parties.

12. In the event of an amalgamation there should be a deemed disposition at the fair market value by the shareholders of the amalgamating companies, but not by the corporations. This should also be true in the case of a transfer by one company of all its assets to another in exchange for securities of the transferee, followed by an immediate liquidation of the transferor. The cost basis and tax treatment of the assets would be carried over to the continuing company.

13. A subdivision, consolidation, conversion, or exchange of shares in the same corporation (or possibly a related corporation) should not be regarded as a disposition if after the transaction each shareholder had the same proportionate participation in votes and in distributions of income and on liquidation as he had before.

14. The transfer of an asset as security for an obligation or its retransfer on the termination of the security should not be treated as a disposition.

TRANSITIONAL PROVISIONS

15. Only gains that accrued after the effective date of the legislation should be taxable, and liberal procedures should apply to determine the value of assets held as at the effective date, which would be the cost basis to the taxpayer. Gains ultimately realized would be taxable only to the extent that the proceeds of disposition exceeded the value at the effective date. This would not apply to inventory or property held for disposal as part of an adventure in the nature of trade, and depreciation taken prior to the effective date would continue to be subject to recapture.

16. Publicly traded securities should be valued at their market value at the effective date. However, if the original cost of such securities exceeded this value, and the securities were disposed of within a period of 3 to 5 years, the original cost would be taken into account in computing a taxable gain, but not a loss.

17. A taxpayer should be entitled to elect, within two years from the effective date, to make a detailed valuation of assets other than publicly traded securities, and to agree on the value with the tax authorities, or have it determined by the courts. As an alternative, if no such election is made with respect to such an asset, the taxpayer should be entitled to apportion the total gain over the time the asset was held or deemed to have been held and to take into account in computing his income only the portion of the gain or loss attributable to the period subsequent to the effective date. For this purpose the period of asset holding prior to the effective date should be the lesser of the actual time held or, say, 10 years. This taxable portion of the gain should be reduced by, say, 25 per cent but no such adjustment should be made for losses.

INCOME FROM HOLDING PROPERTY

18. Interest should generally be brought into income at the time it has been credited directly or indirectly to the taxpayer even though it may not be payable at that time. If the taxpayer is not in the lending business, and in the usual course of events the interest would not be received until the following year, he should have the option of including it in income when received.

19. The reporting of interest paid or credited (as defined) should be required for amounts of $10 or more.

20. Financial institutions, governments, and corporate borrowers should be required to withhold tax at the rate of 15 per cent on interest paid or credited, unless the recipient is a tax-exempt entity which presents an exemption certificate.

21. The reporting of amounts paid as rent should be required.

22. All expenses of earning income, including investment counsel fees, commissions, transfer taxes, and interest on money borrowed to buy income-earning property should be allowed as deductions. Shareholder depletion should be withdrawn.

23. The investment income surtax should be removed.

REFERENCES

1/ The personal enjoyment derived from the use of one's own property, which necessitates forgoing the return that could be obtained from renting the property to others, constitutes a return too; but, as we indicate in Chapter 8, valuation problems preclude including these imputed rents in the tax base.

2/ D.J. Sherbaniuk, The Concept of Income—The Receipts Side, and G.R. Conway, The Taxation of Capital Gains, and, G. R. Conway and J. G. Smith, The Law Concerning Capital Gains, studies published by the Commission.

3/ As we note in Chapter 22, even where an established business is carried on, the gain resulting from the disposition of an asset will be treated as capital if the asset disposed of is part of the permanent structure of the business, for example, a fixed asset.

4/ Californian Copper Syndicate v. Harris (1904) 5 T.C. 159, p. 165.

5/ Toronto Stock Exchange, Origin of Business Study for 1965; Montreal Stock Exchange, Transactions Studies for 1964 and 1965.

6/ Lou Harris and Associates, On the Effects of Reducing the Capital Gains Tax Rate, New York: The New York Stock Exchange, 1960.

7/ G.R. Conway, The Taxation of Capital Gains, a study published by the Commission.

8/ The term "cost basis" should have specific meaning in the Act and would, in some cases, involve certain computations. Basically, it should represent the accumulated cost (including acquisitions and improvements) of the property involved, disregarding any capital cost allowance. In the case of depreciable property, "cost basis" would therefore have the same meaning as "capital cost" in the present legislation. The treatment of recaptured depreciation would continue as under the present legislation.

9/ For details concerning this estimate, see G.R. Conway, The Taxation of Capital Gains, op. cit.

10/ If cash pay-out values remain unchanged, share prices should continue to be influenced by the retention of earnings and the capitalization rate applied to these earnings. However, because under our proposals the cost basis of shares held would be increased by allocations and capitalizations, the taxable gains (net proceeds less cost basis) would be reduced.

11/ For example, in the United States individuals are permitted the deduction of property losses from other kinds of income only up to $1,000 a year.

12/ Mr. Justice Abbott regarded similar events as giving rise to a capital loss in M.N.R. v. Consolidated Glass Company, Ltd., 1957 S.C.R. 167, p. 183. We do not think that the present definition of the word "loss" in section 139(1)(x) of the Act need be retained for this purpose.

13/ We regard a "wash sale" in this context as involving the disposition of property, and the early reacquisition of the same, or similar, property.

14/ Sections 11(13) and 11(1)(c) respectively.

15/ Section 11(2).

16/ Section 32(3).

CHAPTER 16

DEFERRED INCOME

In this chapter we deal with the tax implications of deferring the use of income. The most common deferment is the organized provision for retirement by means of a contractual arrangement which requires the setting aside of income for later use. The principal examples are pensions, profit sharing plans, annuities and similar forms of saving. For our present purposes we shall refer to such arrangements as "retirement income plans". In addition, most permanent life insurance has a substantial saving element.

There is also a second general kind of contractual payment plan in which the saving element, if any, is nominal. This is primarily a means of protection against the immediate loss of income from an unexpected adversity and is not intended as a form of saving. Examples are unemployment insurance, supplementary unemployment insurance, workmen's compensation, weekly indemnity and group life insurance, sickness and accident and other income protection insurance, all of which provide a substitute for the regular income stream when for some reason it ceases. Group life insurance is included in this classification because of the administrative advantages of treating it in a similar fashion to the other kinds of employee benefit plans. We shall refer to such plans as "income insurance plans". Although arbitrary distinctions of this nature are imperfect and certain plans would contain elements of each, retirement income plans are concerned primarily with long-term income maintenance, while the second type of plan is designed to provide shorter term income protection or lump sum payments in the event of income ceasing unexpectedly. Because of the low element of saving in the latter type of plan the income deferment is relatively less important.

In examining various aspects of income taxation, we have been very critical of devices and arrangements that would permit some individuals to postpone tax liability on amounts which are immediately taxable to others. We must therefore face up squarely to an examination of the various issues involved.

In the following pages we review the present tax treatment to appraise the pattern that has already been established. We examine the social and economic implications of encouragement of personal saving. We finally recommend changes to bring taxation in this area more closely into harmony with our concepts of equity and neutrality.

THE PRESENT TAX TREATMENT

We are concerned with the tax treatment of three elements of all plans of the types we have mentioned: (1) payments into the plan; (2) investment earnings or other gains arising from such payments while held for final disbursement; and (3) disbursements from the plan.

Registered Pension Plans

In general, where a superannuation or pension fund or similar plan has been registered with the Department of National Revenue, both the employer under sections 11(1)(g), 11(1)(h), and 76, and the employee under section 11(1)(i) are able to deduct their contributions in computing income in the year they are made, and the earnings of the fund are exempt from tax when earned 1/. The employee does not pay tax on the employer contributions when they are paid into the plan for his benefit, 2/ but all payments from the plan are taxable in full to the recipient 3/. Thus, the beneficiary will include in his income when received, all amounts derived from the following:

1. His own contributions, which he will have earlier deducted in computing income.

2. His employer's contributions which will have been deducted earlier by the employer.

3. The earnings of the fund, which will not have been subject to tax earlier.

Limits are imposed for both the employee and employer deductions. In respect of current services the employee may not deduct more than $1,500.

Contributions by the employee for past service, both while he was a contributor and while he was not, are also subject to limitations 4/. For the employer the maximum deduction in respect of current services is $1,500 for any one employee, but alternatively there is a prescribed formula to limit the deduction where one contribution is made for all employees 5/. On the recommendation of an actuary, the employer may deduct, without specified limit, payments made in respect of an employee's past service in order to fund the plan more fully 6/.

The earnings of a registered pension fund are tax-exempt if it is administered by a separate trust or corporation established solely for that purpose, provided that not less than 90 per cent of the income arises from sources in Canada 1/.

Normally all payments received from a pension fund are taxed at the ordinary rates of the recipient. However, where a lump sum has been paid out, the recipient may elect to be taxed at the average effective rate of tax on his net income before deducting tax credits over the previous three years 7/. Transfers from a pension fund (including retiring allowances) to another pension fund, registered retirement savings plan or deferred profit sharing plan 6/ within the year or within 60 days thereafter are excluded from income 8/.

Although the Canada and Quebec Pension Plans are not registered, their tax position is identical to that of registered plans; contributions of employer and employee are deductible, 9/ income is free of tax when received by the plan, and all benefits are taxed in full when received by the beneficiary.

Registered Retirement Savings Plans

Provision is made for the registration of annuity contracts issued to individuals by certain authorized persons 10/. The purchaser of such a contract may deduct payments up to the lesser of 20 per cent of earned

income or $2,500, unless his employer contributes to a registered pension plan for him, in which case his combined current service contributions under the registered pension plan and the registered retirement savings plans may not exceed the lesser of $1,500 or 20 per cent of earned income. Income of any trust established for such contracts is exempt when earned. Where premiums are refunded on death, a special tax of 15 per cent applies instead of the personal rate. Where a payment is made from a plan which has lost its registration privilege, a minimum tax of 15 per cent is imposed, to be withheld from the distribution. Otherwise, payments of benefits from the plan are taxed at the ordinary rates of the recipient.

Profit Sharing Plans

Profit sharing plans fall into two categories: "employees profit sharing plans" and "deferred profit sharing plans" 11/. They differ from pension plans in that lump sum settlements of the benefits payable under the plan may be made at any time. No tax is levied on the trustee administering the plan in respect of the income of the fund under either type of profit sharing plan 12/.

Under an employees profit sharing plan the employer may deduct his contribution in full in the year it is made, and it must be allocated to the employees, contingently or absolutely. The employee must include his allocation in his income for the same year and pay tax on it whether he eventually receives it or not. Employee contributions, where called for, are not deductible to the employee. The investment income earned is not taxed in the hands of the trustee, but must be allocated to the employees either contingently or absolutely and are taxable to them on such allocation. Therefore, when payments are made out of the plan to the employee ordinarily they are exempt from tax. Provision is made for a tax credit to an employee on withdrawal from the plan at a flat rate of 15 per cent on all amounts which have been allocated to him on a contingent basis but not received by him.

Under a deferred profit sharing plan the employer is allowed a deduction which, when aggregated with his current service contributions under a pension plan, does not exceed $1,500 for each employee. The employee is not allowed to deduct his contributions, but is not required to pay tax on the employer's contribution until a payment is actually received by him from the fund, when tax is payable on all amounts received, including capital gains realized in the fund, less the employee's own contributions and certain other amounts if the plan had previously been a profit sharing plan. Income of the trust is tax-exempt if 90 per cent of the income is from sources in Canada.

In general the taxation of a deferred profit sharing plan is very similar to that of a registered pension plan, the main difference lying in the denial of a deduction to the employee for any contribution he may make. There are also special provisions dealing with the revocation of the registration of a plan and with the appropriation of funds or property of a deferred profit sharing trust to an employer.

Individual Annuities

Each annuity payment is included in income when received, 13/ but a deduction is permitted for the capital element as defined 14/. The definition of "capital element" differs as between contractual annuities and those paid under a will or trust. Under a contractual annuity the capital element in each annuity payment is the proportion thereof that the purchase price for the annuity is of the total payments to be made or expected to be made under the annuity which are calculated on a prescribed mortality basis where life expectancies are involved. Under a will or trust the capital element is the amount which can be established not to have been paid out of the income of the estate or trust.

The general effect of this arrangement is that no deduction is allowed for premiums to purchase a contractual annuity, and no taxable income is imputed to the annuitant for the investment income accumulated on his premiums

prior to payment of the annuity to him. All amounts accumulated up to the date annuity payments commence, either from premiums or from earnings, are considered to constitute capital and therefore are not taxable to the annuitant.

Non-Registered Pension Plans

There are very few pension plans which do not satisfy the registration requirements of the Act. Such a plan is generally based on a contract between employer and employee whereby a portion of the remuneration earned is paid by the employer to fund a plan to make future payments to the employee, either before or after retirement, and is commonly funded by the purchase of an annuity 15/.

In such a plan the employee generally has no right to deduct any of his contributions, and he may also be required to pay tax on the amounts set aside by the employer. Although the practice of the Department is not to allow a deduction for an employer contribution to a non-registered pension plan, the employer may be able to deduct reasonable contributions to some kinds of non-registered plans 16/. Investment income attributable to the beneficiary is generally not taxable until it is paid out to him. When payments are made to the employee under the contract or arrangement, departmental practice is to tax the whole amount received, even though all or some part of the contributions may already have been included in his income. However, if the payment is funded by the purchase of an annuity which is vested in the employee, the employer's contributions would be included in the employee's income when made, and when each annuity payment is received by the employee the capital element would be deductible by him 17/.

Life Insurance

No deduction is allowed to an individual taxpayer for premiums paid on a life insurance policy, and no income tax is imposed on policy dividends

or on the proceeds of a policy when paid out either on maturity or in the event of death. Where the proceeds are paid in the form of an annuity, the tax treatment is that described above for contractual annuities, the capital element being determined at the time the annuity commences.

In most permanent life insurance there is a substantial element of saving, arising primarily from the fact that life insurance policies generally call for the payment of equal premiums over a substantial number of years. This level premium plan results in substantial saving, and therefore significant investment income. The early premiums exceed the real cost of the protection, and the excess is in effect saved to make up the deficiency when the insured is older and the higher cost of protection exceeds the premium. The proportion of the investment income of the insurance company attributable to the policies is not identified with individual policyholders, and is not taxed as being attributable to them. Thus, although there is no specific exclusion in the legislation, property income received by a policyholder through life insurance has not been taxed, either when earned or when received by the beneficiary.

Income Insurance Plans

There are a number of arrangements that fall within the classification we have referred to as income insurance plans. Under the government unemployment insurance plan the employer is allowed a deduction for his contributions, the employees' contributions are not deductible, and benefits are tax free to the recipient under section 10(1)(h) 18/. For workmen's compensation, group accident and sickness insurance and group life insurance the same procedure applies, with the employer receiving a deduction for the premiums paid and the employee generally receiving any benefits free of income tax. There is one case of this kind in which a payment by the employer is taxable to the employee. Premiums paid by an employer for group life insurance in excess of $25,000 on the life of an employee are to be treated as an employment benefit and added to the

employee's income when paid 19/. An individual who is covered by any of these plans is not able to claim a deduction for premiums paid and is not subject to income tax on any benefits received under the plan. The element of investment income in all of these arrangements is also free of income tax but is minor because the premiums are usually relatively small, and total benefits are generally designed to match total premiums over a short period of years. It should be noted that in all of these arrangements income tax is not merely deferred but in fact never imposed.

Summary

The most obvious characteristics to be noted in regard to the present tax treatment of all these arrangements are not only that the treatment is varied, but also that there is extensive tax deferment or exemption. For registered pension plans, deferment is granted for the contributions, both of employer and employee, and for the earnings of the fund; registered retirement savings plans carry deferment benefits for the payments into and the earnings of the fund; in the case of employees profit sharing plans there is no deferment of tax, while under deferred profit sharing plans tax deferment is granted for employer contributions and earnings of the fund. Where contractual annuities are acquired the interest accrued until annuity payments commence is free of tax, while in the case of life insurance none of the profits are subject to taxation. This is also true in the case of income insurance plans which in most cases are ignored for tax purposes.

Another inconsistency in the present system can be found in the treatment of mortality gains and losses 20/. In the case of registered plans these gains or losses are brought into income because the full amount of the proceeds is taxable. The same applies to some extent to non-registered plans, while in the case of income insurance and life insurance the mortality gain or loss is not included in income.

EQUITY AND NEUTRALITY

Under the comprehensive tax base the objectives of equity and neutrality have very great relevance to the tax treatment of retirement income plans and income insurance plans. The attainment of these objectives would imply the following:

1. Tax deferment related to the deduction in computing income of payments into such plans should, in general, be eliminated. If retained for reasons of social and economic policy, deferment should be granted on a uniform basis for competitive types of plans and should be carefully defined. In addition, any deferment should not be in a form that would create a lack of neutrality between businesses because it was available only through some of a number of competing organizations.

2. Any investment income received or accrued through a retirement income plan or an income insurance plan should bear the same tax as if the income had been received directly; also, this tax liability should arise each year and not be deferred. If tax is deferred for reasons of social and economic policy, the tests set out in 1 above should apply. One need only examine Table 16-1 to see that tax deferment can be tantamount to tax forgone.

TAX DEFERMENT APPRAISED

We shall consider the justification for tax deferment, involving as it does a departure from our basic goals of equity and neutrality, under three main headings: social goals, administrative implications, and economic considerations.

Social Goals

It seems to be generally agreed that individuals should set aside a portion of their income in their working years to ensure an adequate command over goods and services in their retirement years. Such private provisions

TABLE 16-1

NET ANNUAL AFTER-TAX RETIREMENT INCOME FOR FIFTEEN YEARS TO BE DERIVED FROM RETIREMENT SAVINGS

Marginal Tax Rate Before and After Retirement (per cent)		Annual After-Tax Retirement Income for Each $1,000 of Annual Before-Tax Income			
		From 20 Years of Saving with Investment Yield of:		From 40 Years of Saving with Investment Yield of:	
		5%	7%	5%	7%
20	N.R.	2,145	2,820	6,840	11,245
	R.	2,550	3,600	9,310	17,535
30	N.R.	1,720	2,190	5,140	7,905
	R.	2,230	3,150	8,145	15,345
40	N.R.	1,350	1,565	3,790	5,135
	R.	1,910	2,700	6,985	13,150
50	N.R.	1,030	1,230	2,720	3,670
	R.	1,595	2,250	5,820	10,960

Notes:

N.R. - Non-registered savings plan: the annual contribution is not deductible because the plan is not registered, and therefore the amount saved would be the balance after the applicable tax liability had been paid. The tax on the investment income is deducted each year and the benefits are not taxable when received.

R. - Registered plan: the annual contribution is deductible for tax purposes so the full amount of income available is paid into the retirement income plan. The investment income is exempt from tax when earned. Benefits are taxable when received.

The following assumptions were made in preparing this table:

1. The before-tax income available for saving each year is $1,000.

2. The before-tax net investment income yields of 5 per cent and 7 per cent a year include property gains and tax refunds on dividends received, but are after expenses. Thus, the effects of our recommendations for the integration of personal and corporate income taxes and the full taxation of capital gains are incorporated into these figures.

3. Average marginal tax rates of individuals were assumed to be the same after retirement as during the years when contributions were made. It is likely that there would be a lower marginal rate of tax after retirement and accordingly the figures would in general understate the value of registration.

4. The retirement income is payable over 15 years in equal monthly instalments and the taxpayer has other retirement income sufficient to make the above-mentioned marginal rates applicable to this retirement income.

5. Any employer contributions are included in before-tax income of the employee and the amounts available for saving include all contributions whether made by employers or employees.

for retirement are thought to foster self-reliance and to reduce the need for the state to provide relief. If in fact this is a desirable social goal, the tax system is one tool available to government to influence retirement saving. Less positively, the government might wish to avoid tax procedures that would discourage such saving. Because Parliament has introduced legislative measures which favour retirement income plans and has broadened them over the years, it can be assumed that this social goal is generally accepted, at least within certain limits. Also, because this legislation has been in existence for a number of years, the concept of tax deferment on this type of individual saving is well imbedded in our system.

Administrative Implications

The administrative problems that would arise in preventing the deferment of tax in connection with pension and insurance plans are also important. In the case of a pension plan, for example, both the employer's contribution and the earnings of the fund would have to be attributed to the employees. The use of arbitrary techniques to meet this requirement in an administratively feasible manner would lead to a number of inequities between employees. However, if a tax procedure were adopted under which most of the members of pension plans remained unaffected by any general requirement to attribute income, the difficulties and inequities would not be so serious. Therefore, a general approach somewhat similar to the present one has definite administrative advantages.

Economic Considerations

Under an expenditure tax an individual would ordinarily be taxed on what he spent in the year and not, as under an income tax, on what he could spend in the year without a reduction in net worth. By allowing taxpayers to deduct their contributions to pension plans from other income, and by taxing them only on what they take out of such plans, thus deferring the imposition of tax on both the contributions and the current income earned

on the assets of such plans, an income tax system is converted into a modified form of expenditure tax. An income tax system is prevented from being transformed by registered retirement income provisions into an expenditure tax system only by setting limits on the amounts that can be deducted from income and by imposing penalties on withdrawals prior to retirement.

This raises three questions:

1. Should the tax system be consciously structured to encourage increased personal saving on economic grounds?

2. Would removal or reduction of the limitations that now distinguish the income tax system from an expenditure tax system serve to increase personal saving?

3. Would this have adverse effects on the allocation of saving?

We will consider each of these questions briefly.

<u>The Need for Additional Personal Saving.</u> As we explain in Chapters 4 and 5, we take the position that until Canada has realized its potential growth rate through the continued maintenance of full employment it would be premature to take steps to increase the growth rate by increasing the rate of domestic saving and investment. To achieve a higher growth rate by maintaining full employment would be economically costless and socially desirable. To achieve a higher growth rate through increased saving would impose a cost in terms of reduced current consumption. It seems to us that it is only reasonable to take costless steps before taking painful steps. Should it be found that the full-employment growth rate was inadequate, then and only then would it make sense to adopt policies to increase the rate of domestic saving.

It is sometimes argued that the rate of domestic saving should be increased to reduce our reliance on foreign saving without reducing the Canadian growth rate. Whether Canadians should or should not reduce their current consumption in order to reduce their reliance on foreign saving is a matter

of preference. The current rate of saving in Canada is high relative to other countries, and we can see no great merit in raising it still further to reduce Canada's reliance on foreign saving. Nevertheless, we acknowledge that increasing the Canadian saving rate to reduce dependence on foreign saving, while maintaining the growth rate, is a perfectly legitimate preference that is commonly held.

Assuming that it was decided as a matter of public policy that the rate of domestic saving should be increased, either to increase the full-employment growth rate or to reduce Canada's reliance on foreign saving, it does not follow that personal saving, rather than the saving of some other economic sector, should be increased. As we indicate in Chapter 4, there are a number of alternative policies that could be adopted to increase the rate of domestic saving. A restrictive fiscal policy to generate a government surplus accompanied by an expansionary monetary policy to encourage investment would be a relatively simple and effective method of increasing the rate of domestic saving and investment without creating inflationary pressures. Accelerated depreciation would probably be a relatively effective method of increasing corporate saving, and should be considered as a viable alternative to a policy designed to increase personal saving. Thus, it is by no means obvious that the rate of domestic saving should be increased or, if it is to be increased, that attempts to increase personal saving would be as effective or equitable as the alternative methods.

There are at least three methods that might be adopted to increase the rate of personal saving if this were thought desirable.

1. Increase the weight of sales taxes relative to personal income taxes.

2. Reduce the degree of progressiveness of the personal income tax rate structure.

3. Liberalize the retirement income provisions so as to bring the income tax system closer to an expenditure tax system.

The less restrictive the provisions under 3 the smaller would be the differences between 1 and 3.

Effects of Concessions for Retirement Saving. In Appendix F to Volume 2, we demonstrate that a partial shift from income to sales taxes, which is what the adoption of method 3 above fundamentally involves, would be equivalent to an increase in the interest rate on retirement saving. There is no conclusive evidence one way or the other that changes in interest rates of the magnitudes that would be involved for low and middle income individuals would have any effect on their rates of personal saving. Allowing high income individuals to deduct their retirement saving from income, and postponing the taxation of the income earned by the assets acquired with this saving, would be equivalent to an extremely large increase in the interest rates on their retirement saving. There can be no doubt that this would encourage upper income individuals to change the form of their saving. However, there is no way of knowing whether they would save the tax reduction or spend it. Probably they would do some of both.

We are inclined to believe that, in the past, liberal retirement saving provisions have had indirect positive effects on saving by low and middle income individuals that probably were as important as, or more important than, the direct effect on the rate of return from such saving. These provisions have encouraged the establishment of pension plans, perhaps to a great extent as a substitute for other kinds of saving that are less generously treated under the tax system. But when pension plans are set up, individuals also become much more "pension" conscious. Because they are forced to consider their lifetime income patterns, there is a change in the evaluation of their future requirements. The discount on future income is reduced, and retirement saving therefore becomes more attractive.

There are two other influences at work. First, participation in a pension plan is often a condition of employment. Those who are not much concerned about the level of their retirement income are often forced to

save for the future or find another job. This element of compulsion probably increases personal saving. Second, because retirement saving cannot be withdrawn at will without limit, low income individuals cannot completely substitute retirement saving for other kinds of saving that are accumulated to meet emergencies, although the introduction of compulsory unemployment, hospital and medical insurance removes some of the major reasons for precautionary saving. All of these factors would seem to suggest that tax provisions that grant a concession to retirement saving probably have encouraged an increase in total saving by low and middle income individuals, although not because of the tax provisions per se 21/.

The introduction of the Canada Pension Plan, which occurred at the beginning of 1966, will result to some unknown extent in a reduction in saving through some registered employer plans. We doubt that the substitution will be complete. If we treat the compulsory Canada Pension Plan contributions as equivalent to private saving, the plan will probably increase total saving 22/.

The benefits under the various government plans, when combined with the benefits under employer pension plans, could well mean that the point is being reached where many couples will have a retirement income as great as or greater than their income before retirement. Unless people put a premium rather than a discount on future income, we doubt that more generous tax provisions would induce low and middle income people in such a position to increase their retirement saving, unless the withdrawal privileges were relaxed to the point where retirement saving and precautionary saving merged. In our view it is likely that over the next few decades those who now have "full" pensions, that is, pensions which equal earnings in the last years of employment, would not increase their retirement saving in response to more favourable tax provisions. Indeed, the reverse is more likely to occur to the extent that the Canada Pension Plan is substituted in part for employer pension plans. However, in those cases where the individual does not have

a "full" pension, employer pension plans will probably improve so that not only will the level of pension benefits grow, but the proportion of the labour force covered by employer pension plans will probably increase. The increase in the labour force will also have an expansionary effect. On balance, we expect that after a temporary setback to adjust to the Canada Pension Plan, the number of members, annual contributions and assets of employer pension plans will all continue to increase about as rapidly in the future as in the past even without a greater concession. As Appendix B to this Volume indicates, this would involve an extremely large tax deferment by 1970. We also believe that for low and middle income groups a greater tax concession would not materially increase the rate of private saving, although the substitution of registered retirement saving for other kinds of saving would be induced if the restrictions on withdrawals were liberalized.

To the upper income groups, retirement saving concessions have greater value because their higher marginal rates of tax mean that the amount of tax deferment is greater; but there is no *a priori* reason to assume that the tax reductions are saved rather than spent. Two things are clear, however. First, the higher the limits on the retirement saving contributions that can be deducted from income, the more certain it will be that upper income individuals will substitute registered retirement saving for other kinds of saving. Second, the higher the limits, the more the system will depart from ability-to-pay taxation. This results from the inability of all taxpayers to utilize the full amount of a large exclusion, and also reflects the fact that the income deferment is a more valuable privilege the higher is the marginal tax rate of the beneficiary.

Institutionalization of Personal Saving. If an individual establishes a one-man registered plan by transferring personal investments into such a plan and he determines the investment policy of the plan, there are no implications for the control of investment capital. However, if the same process is applied to group pension plans it might well shift control of

resources from the individual members of the plans to those managing the funds, depending upon the degree to which investment management is so delegated. To the extent that the investment policies of the institution or the professional management differ from those of the individual, the flow of investment funds would be affected. If institutions are less inclined than individuals toward equity investment, there could be a misallocation of capital growth. However, the shift of voting power in the corporate sector from individuals to institutions is not necessarily an unfavourable trend; corporate management is already to a great extent isolated from individual investors, and knowledgeable share ownership by institutional investors probably has a favourable influence.

The attitude of institutional investors toward risk investments is, however, of significance. Certainly the figures available on investment in Canada indicate that the proportion of trusteed pension savings invested in equity securities is not large, although it is growing rapidly. The Dominion Bureau of Statistics reports show that of over $6.1 billion (market value) invested in trusteed pension plans at the end of 1964, almost one half was invested in federal, provincial and municipal government bonds, and only some 20 per cent was invested in common stocks 23/. This latter percentage is considerably larger, however, than the over 7 per cent at the end of 1952. 24/ Nevertheless, the proportion invested in common stocks by industrial trusteed plans, about 27 per cent, is considerably less than the approximately 50 per cent invested in common stocks by United States corporate pension funds.

Although the reason for this apparent conservatism of Canadian pension plans is not clear, the current tax treatment of such plans, which involves full taxation of the benefit regardless of the underlying source of income, could well be a factor. Thus, the pension fund manager who wants to maximize benefits must compare the high guaranteed yields of a bond or mortgage with the riskier dividend and capital gain yield of a common stock, without the benefit of the dividend tax credit and exemption of capital gains that the

ordinary investor will take into account. A 5 per cent to 7 per cent guaranteed interest rate might therefore compare favourably with a probable 3 per cent to 4 per cent dividend rate plus a possible capital increment. It would still be expected that an overall average long-term yield on common stocks of approximately 9 per cent 25/ should have attracted considerably more interest by financial institutions than it apparently has, particularly in the case of pension funds and insurance companies, where investment decisions should of necessity be based upon long-term factors. Nevertheless, it is clear that equities have been relatively less attractive to pension funds than to middle and upper income individual investors.

The point at issue, however, is whether the proportions of savings invested in equities would have been any greater if individuals had saved directly instead of assigning their funds to institutional management. Any conclusion must obviously be one of conjecture, but if the present trend to increased investment in equities by pension plans continues, it would be questionable to assert that more equity capital would have been available if individuals had managed the assets acquired with their savings. In any event, there is little doubt that the growth of pension funds is contributing to an institutionalization of saving, a trend that is causing considerable discussion because of its uncertain implications for the capital markets.

General Conclusions

Table 16-1 indicates that the value of the tax postponement involved in the tax concessions for pension and retirement savings plans is substantial. For example, if over a period of 40 years an individual has available for investment in a registered pension plan, an annual before-tax income of $1,000 a year, if it can earn a rate of return of 5 per cent, and if he is in a 30 per cent tax bracket, he can build up an after-tax retirement income of $8,145 a year for a period of 15 years, compared with only $5,140 if he saved in the ordinary manner. This is an increase in annual income of almost 60 per cent, a substantial amount. The postponement becomes even

more valuable if the rate of return is higher or if the marginal rate of tax is less after retirement than when contributions were made.

The relatively greater value of this deferment where one's marginal rate of tax is higher is perhaps best indicated by the fact that to put registered plans in exactly the same position as non-registered plans it would be necessary to impose a postponement fee on the investment income of registered plans at a rate equal to the marginal rate of tax of the beneficiary. All payments from the plan would continue to be taxed in full as at present. Even under this approach, saving through a registered plan would be advantageous if the marginal tax rate on retirement were less than when deductible contributions were made, because the tax relief on the capital invested would be greater than the tax paid on the capital element of the annuity payments. Therefore, an individual in a 50 per cent bracket in his working years and a 40 per cent bracket on retirement would still benefit if he saved through a registered plan, even if the registered plan were charged a special, non-creditable, tax of 50 per cent of all investment income earned.

Moreover, and more important, the relative value of the present tax inducement for registered plans would be considerably increased under the recommendations put forward elsewhere in this Report. At the present time, the use of registered plans by those who otherwise would invest directly in common shares is restrained. The full taxation of all benefits paid out of a plan means that any capital gains on common shares held by the plan are taxed and that the dividend tax credit is lost. Under the comprehensive tax base all gains realized by individuals would be taxed, while gains realized in registered plans would be taxed only when eventually paid out in benefits. Integration of the corporate and personal income taxes would result in a refund of the corporate tax to registered plans, the beneficiaries not paying personal tax until the benefits were received. The tax deferment aspect of registered plans would thus become more valuable. Neither of these specific changes should be offset or reduced

by any measure that is applicable only to dividends or property gains. To do so would not only continue the present disincentive to investment by registered plans in Canadian equities, a disincentive that is somewhat in conflict with the declared government intention to encourage Canadian participation in equity investment, but it would also be in conflict with our declared objective of maintaining tax neutrality between various investment forms, for example, bonds and stocks. If any reduction in the tax deferment advantage is contemplated, it should apply equally to all forms of investment income received by registered plans.

We conclude that, in general, tax inducements to encourage retirement income plans should be retained, primarily on the social ground that plans by individuals for income maintenance during periods of adversity or retirement should be encouraged. However, our consideration of the above factors has also led to the conclusion that deferment of income for tax purposes is a very valuable concession, and has sufficiently important implications to warrant placing greater restrictions on its utilization than now exist. In particular, if the justification for tax concessions is primarily social, the value of such benefits should be designed primarily for the low and middle income groups where encouragement of saving is more socially desirable. To the extent that the tax incentive does have an impact on the level of saving, it is largely manifested in the low and middle income groups. We also believe that it is possible to achieve a less complex and more rational approach to the taxation of savings plans of all types.

We shall discuss the implications of these conclusions in detail, first for pension and other retirement income plans, and then for life insurance.

Any type of plan meeting the requirements set out below, whether on an individual or group basis, whether the contributions are a fixed percentage of income, salary or wages, or whether they are on a profit sharing basis, should be eligible for registration. The important restrictions should relate to the provisions for pay-out in the form of pensions, with limitations

on cash settlements, the time of withdrawal and the investment of the funds.

Any unregistered plan should be regarded as a conduit to the beneficiaries. Contributions by an employer and property income that are not distributed or allocated to beneficiaries should therefore, in theory, be taxed at the top personal rate of tax.

RETIREMENT INCOME PLANS

For retirement income plans which can meet the stipulated conditions for registration, we are in favour of continuing to permit the contributor to deduct from income for tax purposes certain contributions to such plans in the year paid, of exempting from immediate tax the annual income on the amounts invested and of including all benefits in the tax base in the year or years in which they are received. The questions to be examined are: first, what types of arrangements should be permitted to qualify for this preferential tax treatment; and second, what specific provisions are required for restricting the deduction of contributions, for the taxation of the income on the savings, and for the taxation of the ultimate benefits. As our proposals concern the limits to be placed on tax deferment, there will continue to be many retirement plans that will not qualify for preferential tax treatment. We also propose specific measures for these non-registered retirement income plans.

Registered Retirement Income Plans

The Canada Pension Plan, and alternative provincial pension plans with equivalent provisions, should be deemed to be registered plans and should therefore be taxed in a manner similar to other registered plans. We recommend that there should be specific rules for the registration of other plans, some of the more important of which are mentioned below. Detailed regulations would be required; but although we have examined such requirements and the overall impact of our proposals in sufficient detail to satisfy ourselves that our recommendations are practical, we only include in this chapter a general discussion of the more important aspects of our proposals. We contemplate that there would be only <u>one</u> set of requirements for all registered plans and that the different rules now applicable to pension

plans, profit sharing plans, and registered retirement savings plans would be eliminated.

1. Contributions by employers and employees should be fully deductible from their incomes until the maximum allowable benefit, as set out in 5 below, had been achieved. There should be no annual limitation, as at present, based upon a percentage of earned income of the employee or on an amount for each employee. This would end the problem of how to limit past service contributions and substantial employer contributions to plans for executives. The procedure would also eliminate the problem for registered plans of how to attribute all the employer contributions to employees, a procedure that would be necessary to enforce a limitation based on annual contributions.

2. Income received by the administrator of the plan should be exempt from tax as long as the plan was registered. Where dividends were received from Canadian corporations, the administrator would be entitled to claim for the plan a refund of corporate income tax paid on the underlying earnings of the corporation.

3. The tax concessions attached to registration should, in principle, be limited to Canadian residents and taxpayers who were permitted to elect to be taxed as a resident. The latter election is discussed in Chapter 26 and essentially is designed to allow Canadian residents who temporarily become non-resident to continue to be taxed as if they had remained resident. However, limiting membership in a registered group plan to Canadian residents would involve the employer and administrator in complex pension arrangements and might become a barrier to labour mobility. Accordingly, while membership prior to retirement in individual registered plans should be limited to persons taxable as residents, there should be no residence limitation for registered group plans, although certain limitations might become necessary if group plans were used as a device for tax avoidance.

4. To be registered, a plan should be administered by a separate trust or corporation in Canada.

5. The maximum allowable benefits for all registered income plans for any tax unit, except as indicated below, should be the equivalent of a single life annuity, with a guaranteed term of ten years, of $12,000 a year for an individual, payable from age 65. This limitation would only apply to establish a common basis of valuation, because benefits could be payable in any one of a number of ways. It must also be emphasized that this is not a limit on what people can save for retirement, but rather a limit on the amount of such savings that would be eligible for preferential tax treatment.

   This formula for determining the maximum amount of deductible contributions, which we refer to as the "basic maximum", appears to be administratively feasible. For administrative reasons we recommend that it should be the maximum for any pension under a group plan. We also recommend that it should be the maximum for all retirement income benefits of each tax unit. However, it would seem reasonable that a family unit which included a married couple should have a higher overall maximum benefit than an individual unit. Such a higher maximum benefit could be acquired under a retirement savings plan, under such a plan together with a group plan, or under a combination of two or more plans, but not under any one group plan. The overall maximum benefit for such a family unit might be the equivalent of a joint and survivor life annuity of $12,000 per annum for the two spouses without a guaranteed period, commencing when the older spouse attained age 65. The younger spouse, if more than ten years younger than the other, would be deemed for this purpose to be only ten years younger than the other. If a family unit acquired more benefits than the basic maximum and then terminated through divorce or legal separation or on the death of one spouse so that one of the former spouses then became the sole beneficiary of the benefit, he or she would be required to bring into income the value of the benefits in excess of the basic maximum, and this amount would presumably be paid out at that time, unless there was a relieving provision which made this

unnecessary where the marriage had lasted a specified number of years at the time the family unit terminated.

The above limitations would apply to the whole family unit and not to each member of the unit. The limits might be lower but should not be higher. However, for convenience these amounts are used in the balance of this chapter. We suggest these amounts, even though they are higher than would be required to meet the social goal of encouraging every taxpayer to provide for a reasonable retirement income, in order to reduce the transitional difficulties which would arise with a lower limit that would affect many of the plans currently in existence. It would allow a margin for individual plans set up with lower benefits in the event that market fluctuations lead to property gains that would provide for larger benefits than had been planned. To facilitate application of the benefit limit, Canada Pension Plan benefits and benefits under any alternative provincial pension plan with equivalent provisions, should be in addition to and not included in this amount. Therefore, total benefits from all registered plans could amount to over $13,000 a year, excluding old age security benefits, without losing the tax deferment privilege.

Such a limit should not pose administrative problems for group plans, because we propose that no plan that provided for or permitted payments to members in excess of this amount would be registered; therefore there would be no point in any beneficiary making contributions in excess of those required to provide such benefits. However, the limit could raise complications in individual plans. For these plans the limit on the balance accumulated in the plan at any time could be a dollar amount based on a standard mortality table used to ascertain the expected life of the taxpayer or spouse and on a stipulated interest rate of, say, 5 per cent. These two factors would be employed to determine the present value of a single life annuity of $12,000 guaranteed for ten years, or

of a joint survivor annuity of the kind described above, payable from age 65 to the taxpayer or his spouse. This present value would be the maximum aggregate market value of assets that would be permitted to accumulate for an individual or family tax unit under all plans. If the market value increased to an amount in excess of this amount, the excess would be included in the taxpayer's income, and in practice would presumably be paid out to him. Market value for publicly traded securities would be readily determinable. For other property the market value would have to be determined in a manner acceptable to the tax authorities.

If a taxpayer who was a member of one group plan joined a further group plan, perhaps as a condition of employment, he would have to attach to his tax return the same certificate (discussed below) as the taxpayer with one or more individual plans. The benefits under each of the plans would be estimated to determine if in total they were within the prescribed limit 26/.

6. Any individual or corporation operating a plan, and desiring to issue the certificates described below, would have to register with the tax authorities and would become a registered administrator. It would be expected that these persons would generally be the same as those authorized to provide certificates under the legislation of the various provinces. To be registered a plan would have to be under the supervision of a registered administrator.

If a taxpayer had an interest in more than one registered plan, he would annually be required to attach to his tax return a certificate signed by the registered administrator of each plan of which he was a member showing the level of the retirement benefits which had been accumulated to that date under that plan. The taxpayer would be required to list in his return all the registered plans of which he was a member. As long as the taxpayer had a beneficial interest in more than one plan, he

would be required to file a certificate annually in respect of each plan, even if he were only contributing at that time to one of the plans. He would not be required to file a certificate if he were a member of only one plan.

7. For a plan to continue to be registered, the administrator would have to comply with certain regulations. For example, he should be required to do the following:

   a) To file an annual statement with the government in respect of each fund under his supervision showing details of investments held, their cost and market value, income during the year, and contributions received during the year.

   b) On the request of a beneficiary, to provide him with an annual certificate stating the level of his retirement benefits accumulated to that date, based where necessary on a number of assumptions that would be set out in the Regulations.

   c) To certify that to the best of his knowledge all the requirements of the legislation had been complied with.

   d) To withhold tax from all disbursements from the fund to non-residents at a rate of at least 30 per cent. A withholding tax at the same rate or a lower rate on payments made to residents might be imposed if required for purposes of enforcement.

8. All payments received from the registered plan or plans would be included in full in the income of the taxpayer in the year received. Withdrawals prior to retirement would therefore be taxed at full progressive rates, although the regular averaging procedures described in Chapter 13 would be available. In addition, the taxpayer could transfer any portion of the proceeds into another registered plan as long as the permitted limit was not exceeded. The present provision for

averaging over three years should be removed. There should also be a special tax of at least 15 per cent levied on all withdrawals prior to age 60 otherwise than on death 27/. This tax should be refundable on any amounts put into another registered plan in respect of the same taxation year, and on that portion of the withdrawal that did not increase the total income of the tax unit for the year over a specified amount of, say, $7,000. A provision of this nature would be necessary to discourage early withdrawals while still allowing the withdrawal of a reasonable amount in an emergency. If the social goal is to provide for retirement, funds generally should be left in the plan except in the case of an earlier emergency.

9. Benefits under a registered plan should be payable to a member of the family unit which made the contributions, or in respect of which they were made by an employer. However, the family unit may terminate with benefits still being payable under the plan. In general this should result in a deemed realization to the family unit as well as being income to the new family unit. However, if such benefits were payable to the taxpayer or his spouse and a new unit was formed, for example, through divorce, separation or remarriage, there should not be a deemed realization. In any such case a gift should not be deemed to have been made, because the beneficiary would be one of the spouses who were members of the family unit when the contributions were made. However, the application of the limitation to the new family unit might result in an amount being brought into income.

If the beneficiary was not the taxpayer or his spouse and was not a member of the family unit, then it should be deemed that there had been a disposition by the family unit of the benefits at a price equal to their value, at the earliest of the following dates:

a) when the benefits become payable,

b) when the beneficiary was not or had ceased to be a member of the family unit and the benefits became fully vested in him, or

c) when the family unit terminated.

This value would be included in the income of the contributors' family unit. It would also be regarded as a gift to the beneficiary, and would be included in his income unless he were eligible himself to qualify the benefits to which he was entitled under a Registered Retirement Income Plan.

10. Payments should begin no later than the seventy-first birthday of the taxpayer or, in the case of a family unit, the seventy-first birthday of the elder of the spouses, and should generally have to be at a level to provide for the complete disbursement of the fund by the time payments to the taxpayer or his spouse would be expected to cease (under standard mortality tables). This would permit the benefits to be taken in the form of an individual annuity or a joint and survivor annuity with or without a guaranteed term. As an individual need not purchase an annuity, it would be necessary for the Regulations to specify the required levels of payments, so that it could reasonably be expected that the fund would be eliminated within the life expectancy of the taxpayer or his spouse. To prevent undue deferment of tax, payments after age 70 should be permitted to accelerate with age only if this is specifically approved by the tax authorities. For example, acceleration should be permitted for increases related to changes in the cost of living or for increases resulting from higher than expected post-retirement earnings of the fund.

11. There should be a requirement for registration with the tax authorities. The conditions for registration should be given legislative sanction in the statute or Regulations thereunder and should set out clearly the requirements for a registered plan. The constitutional power of the federal government to legislate controls of pension plans has been questioned, but there is no doubt that it can and does establish many rules and classifications for income tax purposes which indirectly influence the development of financial arrangements. We think it

important that if the federal government is to extend a tax concession it must retain ultimate control over the application of such a concession. However, to the extent that the provincial governments have enacted acceptable restrictions, detailed federal regulations would not be required.

When an employer contributed to the plan, in order to protect the employees' interests it would be necessary to issue regulations similar to, but more comprehensive than, the booklet (since withdrawn) issued by the Department of National Revenue regarding pension plans (commonly called the Blue Book) 28/. The present rules for registered retirement saving plans under section 79B should form the basis of the regulations for plans established by individuals for themselves or to which the employee alone contributed. However, the permitted investments in the case of individual plans should not be restricted.

To qualify for registration, a group plan should be a bona fide arrangement to provide retirement income for employees, not a disguised form of temporary savings plan. Therefore, the right to convert the benefit into a lump sum by surrender, commutation, or assignment should be strictly limited. The plan should also meet standards of solvency and the investments should be restricted in order to ensure proper diversification. The employee should at all times have a vested right to his own contributions, and there should be reasonable conditions for vesting of employers' contributions, together with safeguards to members if the plan was wound up.

In the case of pension plans regulated by provincial statutes, it would be convenient if provincial registration could be made a condition for income tax relief. However, the provincial acts do not apply to employees profit sharing or deferred profit sharing plans, to individual arrangements or to other types of plans that might seek federal registration. Moreover, it may be many years before all provinces adopt

the uniform Pension Benefits Act now in force in Ontario, Quebec and Alberta. This being so, the whole burden could not be passed to the provinces and it would be necessary for the federal government to set out the rules for registration. If uniform regulations are not implemented by all provinces, the federal government would have to ensure that the regulations adopted by one or more provinces did not have the effect of providing the residents of those provinces with a tax concession unavailable to the residents of the other provinces.

12. The de-registration of any plan for reasons spelled out in the Regulations should cause the full balance to become income of the beneficiary or beneficiaries in the year of de-registration, unless registration were restored within a stipulated period of time. On de-registration a withholding tax of 50 per cent should be remitted by the administrator or trustee and allocated to the beneficiaries of the plan.

13. A taxpayer should have to declare his interest in all plans if he had an interest in more than one plan. Contributions to registered plans should be deductible until such time as the market value of all investments held by all plans for the account of one taxpayer reached the amount required, based upon the standard mortality table and stipulated interest rate, to provide the designated retirement income. If the market value of the investments exceeded this limit for two successive years, any excess existing at the end of the third year should be brought into income. Once one such two-year period had occurred, subsequent excesses should be permitted only for a single year. This provision should not affect a taxpayer who had an interest in a single registered group plan because, regardless of the increment in market values, such a plan would not be permitted to provide for benefits in excess of the limit. Any excess funds in a group plan would probably be distributed by the trustee as a form of return of premium (and

would be taxable income). However, a taxpayer might be a member of more than one group plan, in which case he would have to bring into income each year any excess benefits accruing to him. If this amount was not then paid out to him, an appropriate part of his subsequent pension payments would then be non-taxable as a return of capital.

14. In the case of existing plans, the requirement that any excess benefit should be brought into income should not apply to any amount in the plan as at the effective date. However, further property income of the plan should be brought into income of a taxpayer if the assets in the plan were already in excess of the defined limits. It would be expected that some present group plans would be split in two, with one plan being registered and the other non-registered. The latter would provide for benefits in excess of $12,000 a year. Alternatively, the taxpayer who is in a group plan could, if the plan so provided, be permitted to elect what proportion of his interest in the plan is to be de-registered and in that case he would subsequently bring that proportion of the employer's contributions and of the earnings of the fund into his own income.

In essence, then, our recommendations do not involve any material change for the great majority of existing retirement income plans, but do include a substantial alteration in the method of determining limits for tax deductible contributions. At the present time deductible contributions by an individual taxpayer in any year are limited, either to a percentage of his earned income or to a dollar amount. This procedure is unsatisfactory because it does not adequately take into consideration employer contributions, so that the limitation is unevenly applied to different persons. A better approach would be to allocate the employer contributions to the employees, and then to require that these benefits be included in the income of the employees. However, such an allocation would in many cases be difficult if not impossible. Another difficulty with the present limitation is that it

ignores investment income and therefore confers a relatively greater benefit, in the form of tax deferment on investment income, on those plans that earn a high rate of income.

Therefore, we have recommended that the limitations on tax deductions be shifted from annual contributions to the amount of the benefits that could be obtained from registered plans. Because no beneficiary of a group plan could receive more than $12,000 a year, the use of benefits as a limit would mean that employer contributions would not have to be allocated and that the amount of income accumulated would become a factor in determining when employee and employer contributions were no longer required. The amount of the maximum benefit permitted is a question for arbitrary determination. However, it should be high enough to ensure that the present registered group plans would easily qualify in respect of substantially all of their members, and yet not so high as to extend the privilege of the extremely valuable tax deferment to a level where the social goals are no longer of significance. The amount should also be high enough to allow even major fluctuations in the values of a substantial proportion of individual plans to be encompassed within the limit.

We have pointed out that both the deductibility of contributions to, and the exemption from current taxation of income earned in, a Registered Retirement Income Plan would be extremely valuable concessions. Therefore, it may be thought necessary, now or at some future time, to reduce the value of this incentive. Certainly the loss in tax revenues is immense, and we cannot be at all sure that the same or almost the same level of retirement saving would not be attained without such a substantial incentive.

Any method of reducing the incentive should apply equally to all forms of property income received by any plan, and should not reduce the net rate of return on only one kind of income. We have proposed a limit on ultimate benefits to restrict the use by higher income groups of this valuable deferment. This limit could be reduced, but not substantially, or it would affect

a number of employees in plans that are presently registered. In addition, an upward fluctuation in the market value of the assets held in group plans could have unfavourable tax implications for many taxpayers if the upper limit were greatly reduced. Therefore, if the value of the tax concession were to be reduced, a postponement fee or tax on the total annual income of registered plans would appear to be more appropriate. We think that basically there are two kinds of tax which could be applied to the annual income of the plan, a postponement fee or a withholding tax. Such a fee or tax could be levied on the total income of the plan, including contributions, or on the property income only. Because both of these elements involve tax deferment, a tax on the total income would appear to be the more appropriate.

A postponement fee would be an annual levy on the income of the plan that would not be creditable to the beneficiary. This would amount to a form of interest on deferred tax. The fee should be 10 per cent or less, and would be simple to administer. However, it would be regressive in impact, because it would apply to the amount of income on which tax is deferred and not to the amount of tax deferred.

A withholding tax at a flat rate has undoubted appeal in that the beneficiary would be able to claim a credit for tax paid when the benefits ultimately were paid to him. A flat rate of withholding tax on the total income, that is, on contributions and property income, would be required so that there would be no need to account accurately each year for the proportion of employer contributions and property income attributable to each beneficiary, an accounting that would be virtually impossible to do accurately except in the case of money purchase plans, because of the many actuarial factors involved. However, a flat rate withholding tax would be inequitable as between individuals in different income brackets. A withholding tax would also involve reporting to beneficiaries the amount of tax withheld at the time benefits were paid. To have the same impact on the ultimate level of benefits received after tax, the rate of withholding tax would have to be almost double the level of a postponement fee.

Further discussion of the difficulties encountered with each of these alternatives is contained in our later discussion on the taxation of the proceeds from life insurance. Both procedures would have a relatively greater impact on taxpayers at lower income levels, so that if the intention were to reduce the attractiveness for tax reasons of Registered Retirement Income Plans, the preferable alternative would be to reduce the permitted level of retirement income.

Non-Registered Retirement Income Plans
(Including Ordinary Annuities)

Our proposals are not intended to restrict retirement savings, but rather to limit the amount of retirement savings that is eligible for preferential tax treatment. Plans that could not qualify for registration would not be eligible for the deferment privilege, and no deduction from income for tax purposes would be allowed to the taxpayer for his contributions. An employer would be able to deduct his contributions if they were a reasonable business expense. Consideration must be given to the tax treatment of employer contributions and of income received by the trustee or other administrator, that is, property income earned on contributions while retained in the plan and any other income received, such as gifts and bequests. The ultimate tax treatment of total benefits received from the plan must also be considered. Non-registered plans would include profit sharing plans and any other similar form of savings plan that did not meet the requirements for registration. Individual annuities that were not registered would also fall into this classification.

Annuities which were provided by way of gift present special problems and we deal with the treatment of such annuities in Chapter 17. An annuity which was payable out of a trust should be dealt with in accordance with our recommendations in Chapter 21.

Our concept of an equitable tax system requires that income should be taxed when earned, and taxed in a uniform manner regardless of the form in which it was accumulated or received. In a retirement plan, income is set aside for future use, but when the plan is non-registered, the income should be taxed when first credited to the account of the beneficiary. The intermediary should be regarded as a conduit

through which the cash will flow and anything received by the intermediary, for example, employer contributions and property income, would be received for the account of the beneficiary. Income should therefore be taxable when received by the intermediary, just as if it had been received directly. This tax-paid income would then in effect become capital. Under our recommendation for integration of the corporate and personal income taxes, the procedure for grossing-up and crediting the corporate tax paid to those receiving corporate distributions should apply to non-registered plans in the same way as it would have applied had the beneficiary received the distributions directly.

Because there would be no tax deferment in such a plan, benefits would be regarded as a non-taxable return of investment. If the ultimate benefits received were less than the cost basis of the taxpayer's interest in the plan, that is, the contributions made by the taxpayer and the employer contributions and income which have been attributed to him, there would be a property loss which would be deductible from other income. Over his lifetime a taxpayer would include in income the full realized increase in his economic power, but would not be taxed on any amount that he did not ultimately receive.

We expect that the trustees or administrators of such plans would maintain records of the contributions and investment income attributed, so that when the benefits were paid it would be possible to supply the taxpayer with a statement of his cost basis, that is, original contribution plus attributed income. Any difference between this amount and the ultimate proceeds would be a gain or loss that should be included in the comprehensive tax base.

Although this procedure appears to be relatively simple, in practice it would be complicated by the fact that in many cases it would be very difficult to allocate the employer's contributions or the property income to the beneficiaries. In such an event, a flat-rate withholding tax should be charged against all such unallocated amounts, and later credited on a grossed-up basis to the beneficiary when these amounts were allocated. Thus, on

retirement, the beneficiary of a non-registered plan would receive his pension net of tax withheld. Alternatively, the tax withheld could be refunded to the trustee or administrator so that the beneficiary would receive his full pension, which would be taxable to the extent it exceeded the beneficiary's own contributions and amounts previously allocated to him. Computation of the tax withheld should not be difficult, because a record of the employee contributions and amounts previously allocated to the employee would have been maintained, and any excess of benefits paid over such amounts would in effect represent the amount on which tax had been withheld. To prevent manipulation, the withholding rate should ideally be equal to the highest rate of individual tax, but a rate of 40 per cent would probably be sufficient. Such a rate would cause most employers or individuals to establish their non-registered retirement saving plans in a manner that would permit attribution, even if the allocation rules had to be rather arbitrary. Records would be maintained showing for each beneficiary the total of his own contributions plus the portion of the employer's contributions and income attributed to him. When an amount ultimately vests in the beneficiary, any excess or deficiency of such amount over or under his cost basis would be included in or deducted from income.

INCOME INSURANCE PLANS

Although plans falling within this general classification, for example, unemployment insurance, supplementary unemployment insurance, workmen's compensation, sickness and accident insurance and group life insurance, do not contain a large saving element, so that the relative size of the property income involved is small, the insured does benefit from lower premiums because of the existence of some investment income. Also, there is a mortality or risk element involved and beneficiaries realize a gain or loss because of the sharing of risks through insurance. The major questions for consideration are whether premium payments should be deductible and whether benefits that are ultimately received should be included in income.

The allowance of premium payments as a deduction from income would facilitate the bringing into the tax base of the property income and the mortality gain or loss. As in the case of group pension plans, it is difficult to allocate fairly to each beneficiary his share of both the employer's contribution and the property income, and such allocation should be avoided if at all possible. A procedure that permitted the deduction of all contributions and then brought into income all benefits received would ensure that each beneficiary was taxed only on the net increment in his tax base, regardless of the extent to which the increase in economic capacity was derived from the employer contribution, the property income, or the mortality gain or loss. However, such an approach would also result in the deferment of tax liabilities, with both the premium contributions and the property income accumulating free of tax until eventually paid out in the form of a benefit.

We believe that the deferment of income for tax purposes, at least initially, should be limited to Registered Retirement Income Plans. Ultimately the social advantages of a comprehensive scheme of income deferment might well lead to a "registered deferred income plan" which permitted the deduction of contributions for plans that would provide for benefits in the event that disability, unemployment or death caused the income of the family to decline below a certain level. The proposal for Registered Retirement Income Plans provides only for retirement, although we have suggested a relieving provision which would permit the payment of benefits without penalty prior to retirement to the extent that income of the tax unit in the year, including the amount of the withdrawal from the plan, did not exceed $7,000. We have not suggested the immediate implementation of a more comprehensive income maintenance plan because we believe it would be advisable to obtain first some experience in the operation of our recommended limitation on the deductibility of contributions to Registered Retirement Income Plans. Once the procedures for administering this limitation had been worked out in detail, the registration of more comprehensive plans could be considered.

To obtain the desired administrative advantages without the inequities of a tax deferment, the premium payments to income insurance plans should be deductible and some form of tax should be levied on the total amounts accumulating in the plan. Such a levy, as already discussed, could take the form of either a postponement fee or a withholding tax, but it would have to be applied to both contributions received and property income earned by the plan.

Therefore, we recommend that premium contributions to income insurance plans of both employers and employees should be deductible in computing income in the year paid and that all benefits should be included in full in income in the year received. Because the premiums would be deductible in full by the individual, there would be no need for the employer to allocate his share of the premiums to individual employees. In addition, to reduce the advantages of income deferment that this procedure would encompass, the total income of the plan, that is, premium contributions and property income, should be subject to either a small postponement fee of up to 10 per cent or to a withholding tax of up to 20 per cent.

The postponement fee or withholding tax recommended should not, however, be applied to government unemployment insurance and workmen's compensation. Because the terms of these plans are not established by individuals, and because the plans are not fully funded so that the tax deferment element is not serious, the application of such a tax is not warranted.

Therefore, the full amount of all proceeds received from such income insurance plans as unemployment insurance, workmen's compensation, sickness and accident insurance and group life insurance should be included in full in income in the year received. We recognize that transitional arrangements would be required, and under the heading "Life Insurance" we mention some of the alternatives.

The averaging arrangements proposed in Chapter 13, including the option of converting certain kinds of insurance benefits into registered annuities,

and the proposed treatment of Registered Retirement Income Plans under which substantial single contributions would be deductible in the year of contribution, should remove the hardship that could otherwise result from including substantial lump sum benefits from these plans in income in one year.

FOREIGN SOURCE PENSIONS AND CANADIAN PENSIONS PAID TO NON-RESIDENTS

Pensions received by Canadian residents from foreign sources should be treated as receipts from a non-registered plan. Thus, any benefits received in excess of the taxpayer's own contributions should be taxable in full subject to a credit for foreign withholding taxes on the benefits. One question is whether employer contributions and investment income accumulated prior to the taxpayer becoming a Canadian resident should be deemed to be contributions by the taxpayer. We recommend that this should be the case, because in Chapter 15 we recommend that all new residents should be entitled to assign as a cost basis of their property the market value of the property as at the date they became resident. Membership by a Canadian resident in a non-resident plan should be treated in a similar fashion to membership in any non-registered plan, with the investment earnings of the plan as well as an employer's contributions being included each year in the member's income. The employee would be required to make an estimate of the applicable amounts if he were unable to obtain the detailed figures from the employer.

The Canadian employer contributing to a registered or non-registered pension plan for a non-resident employee would be able to deduct his contributions from income, as he would for any form of employee remuneration. In the case of a non-registered plan, the annual investment earnings attributable to a non-resident should be subject to the non-resident withholding tax, and the dividends or other distributions from Canadian corporations which are applicable to the non-resident interest should not qualify for the refund of underlying corporate income tax. The employer contributions into a non-registered plan would be a taxable benefit, and should be subject to

withholding tax in a manner similar to any other employment income. Payments from such a plan would be a return of capital, and therefore should be free of any Canadian tax.

In the case of a registered group plan (a person taxed as a non-resident should not be permitted to have an individual plan), no tax should be imposed on the fund because the contributions and investment earnings would be accumulated. The non-resident should not be allowed to deduct his employee contributions unless he was eligible to be taxed as a resident. The withholding tax discussed below should be applied to all disbursements from the plan.

Should a Canadian resident become a non-resident, what tax could reasonably be collected by Canada on pensions accumulated for him or subsequently paid to him? We do not think that the deemed realization provisions applicable to other property of a person who ceased to be resident in Canada should apply in this case because of the liquidity problem. Some might suggest that, because these pensions would be received by a non-resident who would be subject to a foreign tax jurisdiction, the basic right to tax should belong to the foreign jurisdiction. However, because the pension benefits would have been built up while the beneficiary was resident in Canada, and in the case of registered plans he would have received special tax concessions while accumulating them and because Canada would be the source of the payment, Canada would have every right to levy tax. In the case of registered plans, part of the payment would represent income earned while the recipient was resident in Canada, but on which payment of the Canadian tax liability had been deferred until retirement. It is therefore reasonable that Canada should collect the deferred tax. It would probably also be necessary to collect this tax to prevent the emigration of Canadians as a result of tax considerations. We therefore recommend that a tax of perhaps 40 per cent or of at least 30 per cent, the general withholding rate for payments to non-residents, should be withheld from the income portion of pension payments to such non-residents. By income portion we mean that

portion of the payment that would have been income for tax purposes if received in Canada. This would exclude that which was deemed to be a return of the investment, that is, the employer and employee contributions and income of non-registered plans that had been attributed to the beneficiary. In the case of withdrawals from a registered plan prior to age 60, the rate of withholding tax should be at the maximum 50 per cent rate to prevent the use of these plans as a tax avoidance device.

Some tax conventions would have to be renegotiated to permit this withholding tax.

The level of the proposed withholding tax raises the question of whether refunds should be allowed. The amounts concerned could be significant for some individuals, so we recommend that such non-residents should be allowed to file Canadian income tax returns as if they were resident in Canada, that is, on a world-income basis. The non-resident could then claim a refund of any tax withheld in excess of the tax that would have been payable if he were resident in Canada. Alternatively, he would be entitled to file an undertaking to submit a return so that the full withholding would not be required. To ensure that there would be no double taxation, it would be necessary to allow a credit for all foreign taxes which were attributable to income from foreign sources. The effect of this proposal would be that the total tax burden on the taxpayer would, in many cases, be substantially the same whether he resided in Canada or abroad.

LIFE INSURANCE

Life insurance is an important feature of the social and economic environment of most Canadians. Approximately three quarters of the families in Canada have acquired life insurance to provide funds in the event of death or in anticipation of some event which would require financial resources 29/. A further indication of the extensive use made of this form of saving is the fact that almost 30 per cent of personal saving is put into life insurance.

An individual who takes out a life insurance policy pays single or periodic premiums and in due course may receive a benefit upon the death of the life insured or upon the maturity of the policy. In addition, the policyholder may receive policy dividends during the life of a policy. The policy may be surrendered for cash before death or maturity.

The amount received from a life insurance policy may be determined by several elements or factors:

1. The return of premiums paid, which is in effect a return of capital,

2. Minus, the expense loading to cover the commissions and other costs involved in issuing and servicing the policy,

3. Plus, the income earned on the investment of these net premiums,

4. Plus or minus, the mortality gain or loss.

Over the whole insured population there should not be a net mortality gain or loss, because the concept of insurance involves the complete offset of individual gains and losses, but individual policyholders will receive either more or less than they contribute.

At the present time no part of the proceeds of a life insurance policy is included in income. The exclusion is not the result of any specific legislative provision but appears to be, to a considerable extent, a matter of administrative practice. Thus,the investment income that is accrued each year to the benefit of policyholders, the policy dividends and the mortality gain or loss are all excluded from income for income tax purposes. The rationale behind this exclusion is not clear, but probably a major reason for the special treatment has been the difficulty of determining how a tax could be levied in an equitable and administratively feasible fashion.

However, life insurance is an important element in the Canadian economy. In 1964, Canadians contributed over $1,300 million in premiums, received over

$800 million in policyholder dividends and other benefits and about $600 million in net investment income flowed to insurers. Amounts of these magnitudes cannot be ignored when determining what is to be included in the tax base. It is inappropriate that one source of property income should have the competitive advantage of offering a complete tax exemption on all investment income derived through that source, particularly in view of our recommendations concerning property income contained elsewhere in this Report. For not only do we recommend that all forms of property income should be taxed in full, but we also recommend that it should be taxed when it is earned regardless of the fact that receipt of the income might be deferred to a subsequent year. Thus, we recommend in Chapter 15 that interest income should be included in the payee's income each year, even if receipt were postponed by the terms under which the investment was made. We believe that a similar approach should be applied to the investment earnings derived through life insurance, and therefore property income accruing to the benefit of individuals through life insurance should be taxed.

Tables 16-2 and 16-3 provide some indication of the relative size of the amounts involved for some standard kinds of life insurance policy. All of the examples are for $10,000 policies and all computations are based upon the requirements for the federal government minimum statutory reserves. In fact, most policy premiums are now based on an assumed interest rate higher than the 3.5 per cent used in these tables together with an allowance for expenses. In addition, in Chapter 24 we recommend that life insurers should pay the full rate of corporate income tax on business income when earned and that policy reserves for tax purposes should be based on an investment yield of at least 4 per cent. Policy reserves represent the accumulated amount provided out of premiums and investment income to meet the estimated future liabilities, based upon actuarial considerations, for policy claims. Thus, one element of this liability account represents the accumulation of investment earnings for eventual

TABLE 16-2

SOURCE OF POLICY RESERVES FOR A WHOLE LIFE POLICY
PAID UP AT AGE 85 FOR $10,000 TAKEN OUT AT AGES 35 AND 50

Year of Age	Net Premium Added in Year (1)	Investment Income Credited in Year (2)	Mortality Loss Debited in Year (3)	Policy Reserve at End of Year (4)
Taken out at age 35 (approximate non-participating annual premium of $175)				
35	$ 25.06	$ .84	$ 25.10	$ .80
45	157.67	52.91	45.38	1,517.20
55	157.67	114.17	87.24	3,288.90
65	157.67	179.21	154.11	5,146.10
75	157.67	239.76	230.53	6,858.00
84	157.67	295.70	221.37	8,524.30
Total for 50 years	7,750.89	7,204.91	6,431.50	
99	—	339.78	—	10,000.00
Taken out at age 50 (approximate non-participating annual premium of $330)				
50	$ 84.10	$ 2.97	$ 83.17	$ 3.90
55	313.69	44.65	114.34	1,204.50
65	313.69	130.79	201.08	3,666.90
75	313.69	212.41	294.50	5,986.10
84	313.69	295.68	221.37	8,524.30
Total for 35 years	10,749.56	5,126.79	7,352.05	
99	—	339.78	—	10,000.00

Notes:

Column (1) The net premium is calculated according to the mortality and interest basis prescribed by the federal government for the minimum statutory reserve, without loading for expenses. This basis is not necessarily the same as the mortality and interest basis used by the insurance company in computing the premium rates it charges to policyholders. The first year net premium is modified to allow for the initial expenses.

Column (2) The investment income for the year is 3.5 per cent (the rate used in arriving at the statutory minimum reserve) of the reserve at the beginning of the year plus the net premium for the year, since premiums are assumed to be payable annually in advance.

Column (3) The mortality loss for the year is the amount chargeable to those that survive in order that the expected claims of those that die in that year may be paid in full. Should death occur at any age, a mortality profit arises in the year of death, equal to the sum assured of $10,000 less the year-end reserve held for the policy.

Column (4) The policy reserve at the end of the year is the total of the policy reserve at the beginning of the year plus the net premium added and the investment income credited and less the mortality loss debited. This amount could be taken to be the "value" of the policy at the year end.

TABLE 16-3

SOURCE OF POLICY RESERVES FOR AN ENDOWMENT, WHOLE LIFE, AND TERM INSURANCE POLICY FOR $10,000 TAKEN OUT AT AGE 40 AND WITH 20 YEARS OF PREMIUMS

Year of Age	Net Premium Added in Year (1)	Investment Income Credited in Year (2)	Mortality Loss Debited in Year (3)	Policy Reserve at End of Year (4)
20 Year Endowment (approximate non-participating annual premium of $425)				
40	$224.71	$ 7.89	$ 34.60	$ 198.00
45	388.85	75.26	41.81	2,184.20
50	388.85	154.10	45.65	4,513.20
55	388.85	248.00	35.15	7,296.40
59	388.85	338.15	-	10,000.00
Totals for 20 years	7,612.86	3,110.45	723.31	
20 Payment Whole Life (approximate non-participating annual premium of $310)				
40	101.86	3.59	35.05	70.40
45	266.00	46.75	46.35	1,337.10
50	266.00	95.82	60.12	2,773.50
55	266.00	151.52	72.72	4,406.20
59	266.00	202.06	76.26	5,897.60
Totals for 20 years	5,155.86	1,900.74	1,159.00	
99	-	339.78	-	10,000.00
20 Year Term (approximate non-participating annual premium of $97)				
40	34.11	1.19	35.30	-
45	81.00	8.88	52.38	209.60
50	81.00	14.01	80.41	335.80
55	81.00	13.83	126.33	282.40
59	81.00	6.30	185.90	-
Totals for 20 years	1,573.11	203.89	1,777.00	

Notes:

Column (1) The net premium is calculated according to the mortality and interest basis prescribed by the federal government for the minimum statutory reserve, without loading for expenses. This basis is not necessarily the same as the mortality and interest basis used by the insurance company in computing the premium rates it charges to policyholders. The first year net premium is modified to allow for the initial expenses.

Column (2) The investment income for the year is 3.5 per cent (the rate used in arriving at the statutory minimum reserve) of the reserve at the beginning of the year plus the net premium for the year, since premiums are assumed to be payable annually in advance.

Column (3) The mortality loss for the year is the amount chargeable to those that survive in order that the expected claims of those that die in that year may be paid in full. Should death occur at any age, a mortality profit arises in the year of death, equal to the sum assured of $10,000 less the year-end reserve held for the policy.

Column (4) The policy reserve at the end of the year is the total of the policy reserve at the beginning of the year plus the net premium added and the investment income credited and less the mortality loss debited. This amount could be taken to be the "value" of the policy at the year end.

payment to the policyholders. Because the stipulated investment yield rate would be employed for computing the allowable deduction to the insurance companies for transfers to policy reserves for tax purposes, it would also establish the amount of investment income that would be deemed to have been accrued to the benefit of policyholders. Thus, the actual amounts of investment income that would be allocated to a policyholder for tax purposes under our proposals might differ from the amounts shown under the column "Investment Income Credited". Nevertheless, the tables give some idea of the relative size of the amounts that under our proposals would have to be included in income for these various policies.

Participating Dividends

The holder of a participating policy is entitled to dividends in addition to the contractual benefits payable on maturity or death or on surrender of the policy. Policyholder dividends are a form of distribution similar to ordinary dividends and to patronage dividends of co-operatives and, like these other distributions, should be included in the tax base of the insured when credited to him. Policyholder dividends may be to some extent a return of premiums paid, but they also represent a distribution of a share of the property income earned and may also be derived from favourable overall mortality experience or from a favourable expense record. In our view, all of the latter three items should be treated as income to the policyholder and taxed as such. The problem is whether all, or only a portion, of the policyholder dividend should be brought into the income of the policyholder. The proportion chosen would not affect the taxable income of the insurer because it would deduct the full amount of such dividends.

Mortality Gains and Losses

We must also consider whether mortality gains and losses should be taken into account in computing income. There can be no doubt that ability to pay is increased or reduced by this gain or loss and that therefore under

our definition of the comprehensive tax base mortality gains and losses should be part of taxable income. In our view, the co-operative nature or mutuality of the arrangement by which individuals, through insurance, decide to pool their risk does not of itself justify special tax consideration. A change in capacity to pay is important, and certain classes of transactions cannot be accorded special treatment without creating inequities. On the other hand, the social argument that individuals should be encouraged to provide for their own protection is significant. Also, because the greatest gains occur as a result of early death, it is apparent that taxing mortality gains may mean the imposition of tax at an inappropriate time, a time when it would be difficult for the beneficiary to understand why a tax liability had arisen. Moreover, the allowance of mortality losses would give a tax refund at a time and for a reason that would be equally difficult to understand.

While the difficulty of explaining the rationale of such taxation concerns us, the argument that gains realized because of the loss of life are not a reasonable subject of taxation cannot be accepted. If it is felt that loss of life warrants some special tax considerations, a special tax allowance or tax credit related to this occurrence should be made available to all taxpayers and not just to those taxpayers who are fortunate enough to be recipients of insurance benefits. Special treatment of insurance benefits compounds the inequities arising on death by assisting only those who are already receiving some compensation.

Another concern is the lump sum nature of this type of income, with a relatively large benefit being received in one year. However, the beneficiary would be eligible for the averaging procedures suggested in Chapter 13, or he could exclude the benefit from current income by making a lump sum contribution to a Registered Retirement Income Plan or to an interest-bearing registered government annuity. The latter two alternatives are extremely important because they would permit a lifetime averaging of insurance benefits in many cases; and in those cases where the benefits were only of moderate

size and were payable to a beneficiary who had little other income, they would result in the payment of little or no tax.

One must also consider the administrative difficulties arising from the inclusion or exclusion of mortality gains and losses in determining the tax base. An apportionment of the proceeds of a life insurance policy, even on an approximate basis, between the various sources of the funds (premiums, investment earnings, and mortality gain or loss), in an attempt to arrive at a specific amount that was to be either included in, or excluded from, the tax base would be a difficult task. If all the proceeds were to be included in income there would be no need to make such an allocation. Another aspect of the administrative question is whether the tax revenues to be gained warrant the effort involved. Mortality gains and losses should compensate over the whole insured population if computed without recognition of the expense element, and there should not be a net revenue gain or loss. Even though the revenue gains and losses might balance out over all taxpayers, the amounts for individual taxpayers would be significant and should be taken into account in determining their ability to pay. Only in this way can equity be attained.

If mortality gains and losses were to be taken into account in the computation of income, and if property gains and losses were to be taken into account on an accrual basis, theoretically the applicable mortality loss should be deductible each year the policy is in effect. This is indicated by Tables 16-2 and 16-3 which appear earlier in this chapter. In other words, the amount to be included in the policyholder's income each year would be the investment income accumulated for his benefit less the mortality loss. The result of this procedure would be to tax the policyholder each year on the increase in his policy reserve less that portion contributed by the taxpayer in the form of the net premium. Thus, the balance of policy reserve in effect becomes the cost basis of the taxpayer's interest in the life insurance policy. On maturity of the policy the mortality gain (or loss) would then be the policy proceeds less the reserve then held by

the insurer in respect of the policy, and possibly less any difference between the gross premiums and the net premiums paid. However, for practical purposes it would probably be more satisfactory to calculate the net mortality gain or loss, that is, the policy proceeds less premiums paid and less investment income credited, at the time the policy matured, and to include it in income at that time. This would avoid the bringing of a large sum into income in one year, as the accumulated mortality losses would reduce or offset the ultimate mortality gain. Alternative approaches to the inclusion in income of mortality gains and losses are discussed in Appendix C to this Volume.

If the policyholder had to pay tax on some portion of his benefits, his insurance would be of less value to him. If mortality gains and losses were to be taken into account, it might be necessary to have special relieving provisions applicable to benefits received during the first five years on policies in existence at the effective date of the legislation, and perhaps it would be necessary to provide an exemption from tax up to a certain amount of policy proceeds. In addition, the cost basis of all policies as at the effective date would have to be determined, because the values built up in the past should not be taxed. For practical purposes the value could be taken as the greater of premiums paid or the cash surrender value as at that time. In any case, this determination could be made by the insurer on the basis of procedures worked out by the industry and the government departments concerned.

Property Income

To tax the investment income earned through life insurance would not constitute the removal of a specifically granted exemption, but rather would be the taxation of gains that have been excluded in practice because of the difficulties of levying tax in an equitable fashion. Taxpayers are taxed generally on investment income and therefore it is not unreasonable to subject to tax immediately investment earnings received or accrued through life insurance. The total amount of investment income accruing each year to

the benefit of Canadian policyholders is substantial, amounting to almost $500 million in 1964, and to continue to exempt an amount of this magnitude from income tax would be most inequitable. In addition, a tax exemption of these proportions may have had a distorting effect on the efficient allocation of saving.

However, not all the investment income earned each year is immediately paid out to the policyholders. A portion will be distributed in the form of policy dividends, but most of the property income is accumulated in the policy reserves until paid out in the form of claims or on cancellation. Elsewhere in the Report we recommend that although most income of the individual should be taxed only when received, it would be necessary to account for many items of property income on a form of accrual basis. We have pointed out the value of tax deferment, and have stated that as a result it would be necessary to regard certain items that are set up as liabilities by the payer, such as interest, to be income to the beneficiary even if payment were deferred until some future date. This approach should also be followed in the case of life insurance to maintain neutrality of tax treatment between various kinds of saving arrangements, and to preclude the use of life insurance as a tax deferment device. Property income accumulated in policy reserves should be taxed in much the same manner as if it had been paid out to the policyholder and paid back by him to the insurer in the form of higher premiums. It will be observed, however, that in many cases the policyholder may be able to arrange with the insurance company for such variations in his policy as would be necessary in order to qualify it for registration as a Registered Retirement Income Plan.

Life Insurance as a Registered
Retirement Income Plan

One proposal for the taxation of life insurance benefits that we rejected was the treatment of most life insurance as a form of Registered Retirement Income Plan. Although life insurance plans are not entirely

comparable to other plans included in this designation, they provide alternative media for the savings of individuals. For registered plans the premiums would be deductible, the investment earnings would be free of tax until paid out to beneficiaries, and the full amount of all benefits would be taxable. Because mortality gains or losses and investment earnings would all be included in the tax base, it would not be necessary to divide the proceeds into their relative components. To ensure equality of treatment between competing forms of saving, registered life insurance contracts would have to be subject to the same requirements for registration that were imposed upon other registered plans, including a limit on the amount of eligible benefits.

Although we considered a number of alternatives, we were unable to develop rules that met both the criteria for registration already discussed and that were capable of encompassing life insurance without leading to unacceptable administrative complexities. The method proposed for the more effective regulation of retirement income plans involves a limit on benefits, a technique that becomes more difficult to administer if a large proportion of the beneficiaries have more than one registered plan. Also, even if most life insurance contracts were registered, there would remain a number of unregistered plans where the sum assured exceeded the prescribed limits for registered plans, and therefore it would still be necessary to provide for the allocation of some investment income.

We therefore concluded that life insurance should, in general, be treated in a manner similar to non-registered retirement income plans.

It should, of course, continue to be possible for life insurers to register and sell life insurance contracts that meet the requirements for retirement benefits already suggested, as they now do under section 79B plans. It should also be possible to vary existing policies so that they would meet the criteria for registration and to register such policies if they comply with the requirements. Thus, competitive neutrality could be maintained between the various savings media.

The Proposal

Our recommendations for life insurance are that:

1. Premiums paid for a life insurance policy, other than for group life insurance which we discussed under the heading of income insurance plans, should not be deductible in computing income unless the policy was registered as a Registered Retirement Income Plan in the manner already specified.

2. In general, the property income accumulated for the benefit of the policyholder should be included in his income in the year it was accumulated in the hands of the insurer. This procedure would be consistent with that recommended for investment income accrued by other financial intermediaries and not immediately paid to the beneficiary. Alternative procedures by which the property income would be subject to a postponement fee or withholding tax when accrued by the insurer, are discussed in Appendix C to this Volume.

3. The entire policy dividend should be included in the income of the recipient, a procedure similar to that recommended for patronage dividends of co-operatives. A withholding tax of 15 per cent, as recommended for interest and certain other payments, should be deducted.

4. Mortality gains and losses should eventually be included in the computation of the income of policyholders. In the case of the other contractual arrangements that give rise to mortality gains or losses, such as, annuities, some pension plans and income insurance plans, we have recommended that such a gain or loss should immediately be included in the comprehensive tax base. However, we do not recommend the immediate inclusion of mortality gains and losses from life insurance, other than from group life insurance, unless their inclusion would be essential to an administratively feasible system of taxing the other income elements of life insurance. The exclusion of mortality gains

and losses would omit life insurance proceeds from income and disallow the deduction of premium payments 30/. We recommend that the inclusion of mortality gains and losses in the tax base should be postponed, because our other recommendations involve a substantial change in the tax treatment of life insurance and we would prefer that the impact of including mortality gains and losses in the computation of income should not arise at the same time.

The taxation of policy dividends would pose few administrative difficulties because the amount of such dividends is already reported annually to policyholders. As in the case of the patronage dividends of co-operatives, we recommend that the full amount of policy dividends should be included in income because of the futility of attempting to designate a reasonable amount that could be considered to be a return of premium. Although such an arbitrary procedure may appear inequitable when mortality gains and losses are excluded from income, the eventual taxation of the excess of policy proceeds over premiums paid would remove any possible inequity because the gross premiums would be taken into consideration when determining the final tax liability.

In the case of the property income accrued as part of the policy reserves of the insurer, an allocation to individual policyholders would be a new procedure. However, the reporting of such income to policyholders should be relatively straightforward, particularly because well over one half of the holders of policies outstanding are already receiving notices concerning annual distributions, that is, the participating dividends. Also the determination of the amount of the allocation should not be unduly complex because the insurer must maintain, as a necessary basis for his statutory valuations, detailed records of the reserves held under each kind of policy. Because it is the investment income credited each year to the policy reserves for tax purposes that is deducted in computing the taxable income of the insurer and is accumulated for the benefit of the policyholder, it is this amount that should be allocated annually to the policyholders. Any amount that the insurer does not allocate should be subject to a substantial withholding tax, a tax that should subsequently be refunded to the insurer when the applicable investment income has been allocated to a policyholder. Although the

allocation would not provide the policyholder with cash from which to meet this tax liability, we do not feel that the liquidity problem would be particularly serious, because the amounts involved each year would usually be relatively small in comparison with the other income of the policyholder. In any event, the policyholder who was concerned with liquidity could qualify his policy as a Registered Retirement Income Plan and thereby defer payment of tax until he received the policy proceeds.

A major advantage of the recommended allocation is that the policyholder would pay the full tax liability and the cash flow of the insurer would therefore not be reduced. Thus, the insurer could continue to provide for its contractual liabilities in the same manner as at present. This effect, when combined with the initial exemption for mortality gains and losses, means that the initial proposal could be implemented with very few transitional provisions. For example, there would be no need to value the policies outstanding as at the effective date.

However, we suggest one exception to the general requirement that investment income be allocated. There are some kinds of policies, which would be specifically defined and would include most term insurance, that have relatively small reserves and thus little investment income. In such cases a detailed allocation would not appear to be warranted and the application of a substantial withholding tax would not be reasonable. We therefore recommend that the insurer should be permitted, at his option, to pay a flat-rate tax of, say, 20 per cent on the investment income credited to the reserves held for such policies. This tax would be in lieu of any personal income tax on such investment income, so that allocation to policyholders would not be required. Although the application of progressive rates of tax would be forgone, the saving element is small and the inequity would be minor, while the reduction in administrative complexity would be significant.

The recommendations we have made in this chapter are stated in general terms. It would be necessary for the tax authorities to work out, in association with representatives of the life insurers and the Department of Insurance, the detailed regulations that would apply. Although we believe that the detailed procedures for implementing our proposal for the allocation of investment income to policyholders can be developed with the co-operation of these three groups, it is possible that such an approach would place too great an administrative burden on the insurer. We have therefore set out, in Appendix C to this Volume, two alternatives that should be considered if our primary proposal for the allocation of investment income proves unacceptable. As we have mentioned, one of these alternatives involves the immediate inclusion in the computation of income of mortality gains and losses realized through life insurance, a proposal that we would endorse if it was a necessary part of the taxation of accrued property income.

CONCLUSIONS AND RECOMMENDATIONS

REGISTERED RETIREMENT INCOME PLANS

1. The Canada Pension Plan and alternative provincial pension plans with equivalent provisions should be deemed to be Registered Retirement Income Plans so that contributions would continue to be deductible, earnings of the fund would continue to be exempt from tax, and benefits would continue to be taxed in full.

2. The extent to which contributions to other Registered Retirement Income Plans (to include pension plans, retirement savings plans, profit sharing plans and life insurance) are deductible from income should be based upon benefits. There should be only one set of requirements applicable equally to all registered plans, with no distinction by kind of saving plan. There should be no annual limit on deductions, but contributions by both employer and employee should be deductible from income only as long as the retirement benefits to the taxpayer from plans other than the Canada Pension Plan (or an alternative provincial

pension plan with equivalent provisions), calculated on specified assumptions, does not exceed the <u>equivalent</u> of a single life annuity of $12,000 a year, payable at age 65 with a ten-year guarantee. A family unit which includes a married couple should be permitted to make additional contributions to an individual plan or to any second plan, subject to certain restrictions, to provide total retirement benefits <u>equivalent</u> to a joint and survivor life annuity of $12,000 per annum for the two spouses without a guaranteed period, commencing when the older spouse attained age 65. Benefits could be paid in the form of an individual annuity or a joint and survivor annuity commencing not later than age 71 with or without a guaranteed term.

3. In the case of existing plans that have accumulated assets in excess of those required to provide the maximum benefit, contributions and property income should no longer be treated as income of a registered plan. Thus, such contributions would not be deductible and the property income would have to be included immediately in the income of the beneficiary. However, the "excess" assets accumulated to date should be permitted to remain in the plan and should not be brought into the income of the beneficiary until distributed.

4. The trustee or administrator of a Registered Retirement Income Plan should continue as at present to be exempt from tax on the property income received. Dividends from Canadian companies received by the plan should qualify for a refund of the 50 per cent corporate income tax paid on the underlying earnings.

5. Membership in a registered individual plan prior to retirement should be limited to Canadian residents or former Canadian residents who elect to continue to be taxed as such. Membership in a registered group plan should not be limited by residence.

6. There should be a requirement that employer's contributions and property

income in excess of an amount required to provide the $12,000-a-year benefit mentioned above must be distributed or attributed to the beneficiary. This requirement should apply to all registered plans other than those referred to in 1 above, including those at present outstanding. Amounts so paid or attributed would be taxable in the hands of the beneficiary.

7. All withdrawals and benefits received from registered plans should be taxable at full progressive rates. There should also be a special 15 per cent tax on withdrawals prior to age 60 otherwise than on death. This tax should be refundable only to the extent that the withdrawal does not increase the income of the tax unit over $7,000 for the year.

8. The present requirements for registration should be strengthened. Annual reporting to the tax authorities should be required, and every such plan should be under the supervision of a registered administrator. To maintain his registration, an administrator should have to comply with certain regulations.

NON-REGISTERED PLANS

9. Non-registered plans, including ordinary annuities, should be treated as conduits for the individual beneficiaries. Contributions by the beneficiaries should not be deductible. Any property income or employer contribution not attributed to an individual, and included in his income, should be subject to withholding tax at a rate close to the maximum individual rate of 50 per cent. Such plans which receive distributions from Canadian companies should be entitled to credit for the underlying corporate tax in the same manner as we recommend for other taxpayers. Any foreign plan would be treated as a non-registered plan.

10. The cost basis of a non-registered plan would consist of all amounts contributed by the tax unit and all amounts attributed to that tax unit and included in its income. The difference between what was received

out of the plan and the cost basis would be a gain or loss that should be taken into account in computing income.

INCOME INSURANCE PLANS

11. All benefits received from income insurance plans (unemployment insurance, supplementary unemployment insurance, workmen's compensation, sickness and accident insurance and group life insurance) should be included in income. Contributions of employers and employees should be deductible in computing their income. To reduce the value of the tax deferment involved in this procedure, the total receipts (contributions and property income) of the plan for the year should be subjected to a small postponement fee or to a withholding tax. Government unemployment insurance and workmen's compensation plans should be exempt from this fee or tax.

PENSION PAYMENTS TO NON-RESIDENTS

12. The income portion of pension payments made to non-residents should be subject to a withholding tax of at least 30 per cent. However, a non-resident should be entitled to elect to file a return as a Canadian resident, reporting his world income including the pension payment and claiming a credit for foreign tax on his income from foreign sources.

LIFE INSURANCE

13. Premiums paid (with the exception noted below) should not be deductible and the investment income attributable to the policyholder, that is, the investment income credited to the reserve held for his policy, should be allocated to him each year and included in his income for that year. Initially the proceeds of a Canadian life insurance policy received by the tax unit that made the premium payments should be excluded from its income. Policy proceeds received by other tax units are in effect gifts and should therefore be included in full in their

incomes. Policy dividends should be subject to a 15 per cent withholding tax, and should be included in full in the income of the policyholder. If a life insurance policy was registered as a Registered Retirement Income Plan, it should be treated in the same manner as other such plans. Mortality gains or losses from life insurance should eventually be included in income.

REFERENCES

1/ Section 62(1)(q).

2/ Section 5(1)(a).

3/ Section 6(1)(a)(iv).

4/ Section 11(1)(i).

5/ Section 11(1)(g) and Regulations, section 2700.

6/ Section 76.

7/ Section 36(1). Since April 26, 1965, a limit on the amounts eligible for this special rate of tax has been imposed by sections 36(5) and 36(6) to prevent abuse.

8/ Section 11(1)(u).

9/ Section 11(1)(x).

10/ To qualify under section 79B, the annuity must mature by the time the annuitant attains age 71, be for life or for the joint lives of an annuitant and his spouse or the life of the survivor, and may have a guaranteed period not exceeding 15 years. The plan must provide that there shall be no realization or commutation of an annuity or benefit before maturity except by way of refund of premiums on death. Section 79B applies not only to contracts for the purchase of an annuity, but also to arrangements whereby payments to a corporation in trust are to be made for the purpose of providing an annuity at a fixed maturity date. The same tax consequences follow as set out in the text.

11/ Section 79 and section 79C respectively.

12/ A deferred profit sharing plan, like a pension plan but unlike an employees profit sharing plan, must be registered. In order that it

be registered, amounts paid in must be allocable to employees, the employees must not be able to surrender, assign or borrow on their interest in the plan, and direct investment must not be made in the employer's obligations directly or through a company.

13/ Section 6(1)(aa).

14/ Section 11(1)(k) and Regulations, section 300.

15/ Plans which provide future payment for present services should be distinguished from plans which, at least ostensibly, provide future payment for future services. Deferred compensation plans which contemplate future services, such as consulting services by executives, are dealt with in Chapter 14.

16/ There is British judicial authority which suggests that such payments are deductible. See J. S. Hausman, "Non-statutory Deferred Compensation Plans", Canadian Tax Journal, Vol. XIII, 1965, p. 402.

17/ Section 11(1)(k).

18/ For supplementary unemployment benefit plans authorized by section 79A, amounts paid by the employer are deductible and no tax is paid by a trust while governed by such a plan. However, amounts received from such a plan are taxable.

19/ Section 6(1)(db).

20/ The mortality gain or loss is the difference between what each person having an interest in an annuity, pension plan, life insurance policy or similar form of contract receives and what he contributes directly (by contribution or premium) or indirectly (by reinvested property income). Whether this difference amounts to a gain or loss will depend upon whether (and when) the insured-against event occurs within the term of the plan or policy.

21/ A detailed discussion of the effect of the growth of pension plans on the rate of individual saving is contained in Philip Cagan, Effects of Pension Plans on Aggregate Saving, Occasional Paper No. 95, New York: National Bureau of Economic Research, 1965. A less detailed analysis, but one concerned particularly with Canadian Registered Retirement Savings Plans, is contained in Robert N. Schoeplein, Taxpayer Participation Under the Registered Retirement Savings Program, Canadian Journal of Economics and Political Science, May 1966.

22/ This depends on the uses to which governments put the funds raised, and what would have happened to government revenues in the absence of the plan.

23/ Trusteed Pension Plans, Financial Statistics, Ottawa: Queen's Printer, 1964, Dominion Bureau of Statistics, Table C.

24/ Survey of Canadian Trusteed Pension Funds, 1953—a much smaller survey than that conducted in 1963.

25/ This figure is an estimate made of the average compounded annual before-tax rate of return (with dividends reinvested plus gains and less losses) of all common stocks listed on the New York Stock Exchange for the 35 years from 1926 through 1960, a period that included the Depression and World War II. L. Fisher and J.H. Lorie, "Rates of Return on Investments in Common Stocks", Journal of Business, Vol. XXXVII, 1964, p. 9. Although the yield on Canadian equities has not necessarily been the same, the performance of the Canadian stock market has not differed materially from the United States record.

26/ Where the pension rights accumulated to date were related to future income, the assumption would be that the taxpayer's income would continue at current levels, unless there was evidence to the contrary.

27/ While we have suggested a limitation on withdrawals by reference to a

stated age, it might be considered desirable as an alternative to provide for withdrawals prior to this age, subject to suitable restrictions which would permit the retirement income to be payable in monthly instalments from maturity which would be equal except to the extent necessary for integration with the Canada Pension Plan and old age security payments.

28/ Department of National Revenue, Statement of Principles and Rules Regarding Pension Plans, Ottawa: Queen's Printer, 1959.

29/ Canadian Life Insurance Association, Canadian Life Insurance Facts, 1964, Toronto: Canadian Life Insurance Association, 1964.

30/ The exclusion would be accomplished by specifically excluding from income the proceeds received from a Canadian life insurance policy on death, maturity and cancellation. In addition, the mortality gain or loss attributable to a policy that was qualified as a Registered Retirement Income Plan should be excluded from the income of the tax unit that paid the premiums. However, we are also recommending that the comprehensive tax base should include gifts and bequests received by a taxpayer. As the receipt of the proceeds of a life insurance policy by a tax unit other than the unit that paid the premiums (and was credited with the investment income) amounts to a gift, then the exclusion would have to be limited to the Canadian life insurance proceeds received by the same tax unit that paid the premiums and was credited with the investment income.

CHAPTER 17

GIFTS, INCLUDING INHERITANCES

In this chapter and elsewhere in this Report the term "gift" refers to any gratuitous receipt, whether or not it is a gift in the technical sense, unless the context requires another meaning. It includes a transfer for inadequate consideration to the extent of the inadequacy. It also includes a bequest or device or transmission under intestate succession laws. The term "donee" refers to the recipient of any such gift. "Donor" includes a deceased person who leaves property, and also a person who sells or transfers property for inadequate consideration.

The allocation of taxes according to ability to pay requires the imposition of progressive rates of tax on a tax base that measures the change in the economic power of each individual and family. No one can doubt that gifts increase the economic power of those who receive them, for they either "save the pocket" or provide an asset that can be exchanged for consumer goods and services. We recommend that gifts from one tax unit to another should be brought into the comprehensive tax base of the recipient in the same way as wages, business income, dividends, interest, rents, property gains and windfall gains. As we have stressed, the source of a gain and the expectations and intentions of the recipient of a gain are completely irrelevant. Anything that increases an individual's or a family's capacity to command goods and services should be included in the tax base. However, in order to simplify administration, by reducing the need to value and account for many small gifts, we will propose that there should be certain annual exemptions, as well as a lifetime exemption, for gifts received.

While this chapter is primarily concerned with gifts from the point of view of the recipient, we want to emphasize that the inclusion of gifts in the tax base of the donee would not mean that gifts should be deducted from the tax base of the donor. The only deductions we recommend are expenses which are reasonably related to the earning of income, and certain special

types of deductions such as charitable donations within specified limits. *Inter vivos* gifts are a voluntary exercise of the donor's economic power. They are personal expenditures that should be treated in exactly the same way as personal consumption expenditures. Neither *inter vivos* gifts nor testamentary gifts are related to the earning of the donor's income. Indeed, as we have said in Chapter 15, a gift from one tax unit to another is a disposition of property and the gain, if any, calculated on the basis of the fair market value, should be brought into the tax base of the donor. In other words, gifts should be made only from tax-paid income.

To prescribe that gifts must be made from the tax-paid income of the donor and that they are income to the donee does not in our opinion involve "double taxation". We simply recommend that all income be taxed once to each unit that received it. No one thinks that the taxation of a worker's wages and the taxation of a merchant's profit derived from selling goods and services to the worker is "double taxation". The merchant must include the price of the goods or services in his income, while the worker cannot deduct that amount, because it is a personal or living expense. Our approach to gifts is basically the same.

We have taken the position in this *Report* that consumption and savings should be taxed on the same basis. This means that changes in the taxpayer's *capacity* to command goods and services for personal use should be taxed, and not only the command actually exercised. On the basis of this test, the donee should be deemed to have received a gift when he has received the right to it rather than when he exercised the right. Any other approach would make it possible to arrange gifts in such a way as to achieve an unwarranted deferment of tax. As we have said, postponed taxes are less onerous taxes and are unfair taxes because the ability to postpone is not available to everyone to the same extent.

The family unit concept that we recommend in Chapter 10 has important implications for the taxation of gifts. The recommendations set forth in

this chapter are predicated on the adoption of the family unit concept. Under that concept, transfers of wealth within a family unit would not be subject to tax, just as a transfer of cash from one pocket to another is outside the scope of the present system. Only transfers of wealth between tax units would have tax consequences. By recommending that spouses and their dependants should form a family unit for tax purposes, and by stipulating that it should continue until the death of the last surviving spouse or until all children have lost their dependant status, whichever comes later, the tax system we recommend would probably exempt from tax a large proportion of all gifts. Professor Carl Shoup, in his study of death and gift taxation in the United States, has estimated that well over one half of all transfers are among persons who fall within our definition of the family unit 1/. While comparable data are not available for Canada, we expect that a similar proportion prevails here.

In Chapter 10, we explain why we recommend that transfers between spouses and between parents and dependent children should not have tax consequences. It is our view that the property is accumulated by a family as a result of joint decisions and a common effort of both husband and wife, either in earning or in refraining from spending. Accordingly, it should be possible to transfer property freely and without tax consequences within the family unit. Children should be included in this unit during the period when they are the financial responsibility of the parents and unable to support themselves. In some circumstances the income of children increases the economic power of families; and when this occurs the income of dependants should be aggregated with the income of the family. We believe it would be neither desirable nor feasible to differentiate between the expenses of parents that are legal or social obligations, and expenses that are essentially gifts from parents to their children. For these and for other reasons relating to the need to aggregate family income, we believe that the consumption of dependants should be treated as family consumption; and the money saved by children, unless kept outside the family unit through the deposit system we suggest, should be treated as family saving.

There comes a point in the life of most children when they both want and need independence. They are capable of making their own way. Because this point is difficult to define, we have specified a number of conditions and have provided certain options to accommodate the diverse circumstances that exist. It is our approach that prior to reaching this point in their lives children have no ability to pay taxes except as members of a family unit. But having become independent, they immediately acquire an ability to pay taxes. As in the case of other individuals and families, their ability to pay depends on what property they receive in the form of gifts, on what they earn, and on their own obligations and responsibilities. Accordingly, we propose that when a child leaves a family unit, he, or his new family unit if he has married, should include in income the market value of all property taken from the original unit. This would be subject to the lifetime exemption for gifts to each individual in the amount of $5,000 that we recommend later in this chapter. The smaller annual exemptions which we propose should also apply, and the averaging provisions which we discuss in Chapter 13 should be available with respect to this income.

When a new tax unit is established, its biggest asset will often be the health, strength and knowledge of the new taxpayer; but because we do not propose to tax human capital, this is not taxable to the new tax unit. Apart from the administrative exemptions referred to above, this would be the only net gain of the new tax unit that should not be subject to tax. All of the money and other property brought into the new tax unit should be taxable to that unit as income. This applies to property taken from the child's original family unit on termination of his dependant status and anything subsequently received from the original unit, as well as income subsequently earned by the child or other members of his new unit.

Some children will have greater material advantages than others because their families are more affluent. The proposed system ensures that well-to-do parents who support their children lavishly can do so only by spending income taxed to the family at progressive rates. Some children will receive

substantial gifts from their parents either before or after losing their dependant status. The proposed system would not eliminate this advantage; but it would ensure that these gifts were taxed to the newly independent individual at the same rates as other gains.

In summary then, our approach to the taxation of gifts and bequests would have two major effects. First, it would completely remove the tax burden from gifts and bequests flowing from the taxpayer to his spouse and dependent children. Second, our proposals would in general increase the tax burden on other gifts and bequests that exceed the exemption level. Thus, a widow would be free of tax on transfers from a deceased spouse,while large transfers between generations would usually be subject to substantially higher tax, although not higher than the recipient would pay on any other kind of income.

THE PRESENT SYSTEM

Under the present tax system gifts are not included in the income of the recipient. Taxes are imposed on gifts, but the provisions for taxing _inter vivos_ gifts are quite different from and independent of those which tax gifts of property passing on death.

Inter Vivos Gifts

Part IV of the _Income Tax Act_ imposes gift tax on donors of _inter vivos_ gifts made by individuals and personal corporations. The aggregate taxable value of gifts made by a donor is calculated annually. After excluding gifts which are exempt under the provisions referred to below, the remaining gifts are reduced by a deduction equal to $4,000 or one half of the difference between the donor's taxable income and the tax thereon for the preceding year, whichever is greater. The resulting aggregate taxable value is subject to tax at a flat rate which varies from 10 per cent, where the aggregate taxable value does not exceed $5,000, to 28 per cent, where that value exceeds $1,000,000. The donor is primarily liable for the tax, but if he fails to pay, the donee is

jointly and severally liable with him. Gifts out of a community of property are considered to be given partly by each spouse.

The term "gift" is not given a broad meaning in Part IV of the Act 2/. However, a general tax avoidance section provides that where one person confers a benefit on another the payment may, depending on the circumstances, be deemed to be a disposition by way of gift 3/. This provision might apply in the case of a transfer for inadequate consideration, or any other transaction or series of transactions which results in a measurable benefit being conferred directly or indirectly.

Part IV of the Act specifically exempts gifts taking effect on the death of the donor, because these will be subject to estate tax. It recognizes the idea of the family unit to some extent by providing a once-in-a-lifetime exemption of $10,000 for a gift of real property (a) to a spouse, if the property is to be used as a place of residence by the parties, or (b) to a child, if the property is to be used in farming operations. Gifts to certain charities are exempt, as are gifts to the federal government or provincial or municipal governments. Where the value of all gifts to one donee in a year does not exceed $1,000, such gifts are exempt, presumably for administrative reasons, and are not included in computing aggregate taxable value.

The gift tax provisions were originally introduced in 1935. The present rate structure has been in force since 1942. Since the introduction of the present Income Tax Act in 1948, the only significant change has been the introduction in 1958 of the once-in-a-lifetime exemption of $10,000.

Property Passing on Death

Where property passes on the death of an individual, it is not subject to gift tax but it may be subject to estate tax under the Estate Tax Act. This tax is imposed in two situations. Where the deceased was domiciled in Canada at the time of his death, all property passing on his death is taken into account in computing the aggregate taxable value which is taxed at

progressive rates. Where the deceased was domiciled outside Canada at the time of his death, his property then situated in Canada which passes on his death is taxable at a flat rate of 15 per cent, although this is reduced where provincial duty has been paid on the property.

In the case of a person domiciled in Canada the property passing on death is valued and reduced by the debts. The resulting aggregate net value is reduced by a standard deduction of $60,000 if he had a dependent spouse and $40,000 otherwise, and by deductions of $10,000 or $15,000 for each dependent child. It is also reduced by certain gifts to charities. The resulting aggregate taxable value is subject to tax at progressive rates which start at 10 per cent and reach 54 per cent on amounts in excess of $2,000,000. If the deceased was domiciled in a province which imposes succession duties (Quebec, Ontario or British Columbia), or has left property situated in such a province, a provincial tax credit is allowed. In the cases of Quebec and Ontario this credit is equal to one half of the applicable estate tax, while in the case of British Columbia it is equal to three quarters of the estate tax. If any of the property was situated in a foreign country and was subject to foreign estate taxes or succession duties, a foreign tax credit may be claimed to the extent of the estate tax applicable to the property. The executor of the estate is primarily liable for the tax on property under his control. Each successor is also liable for the estate tax applicable to property which passes to him.

The Estate Tax Act contains numerous specific provisions as to what amounts are to be taken into account in determining the value of property passing on death. Many of these are based on similar provisions in the United Kingdom legislation. For example, property disposed of by the deceased during his lifetime may be included if he has reserved a benefit or other interest. A gift or transfer for partial consideration which is made within three years prior to death is also included. However, if gift tax has been paid on the disposition, this will be allowed as a credit against estate tax thereon. If the gift tax exceeds the estate tax on the disposition, the excess is refundable to the person who has paid the gift tax.

Interests in annuities, trusts or other property which arise on death are included if provided by the deceased alone or by arrangement with others. Pensions, death benefits, and payments from a former employer of the deceased in recognition of his services are also taken into account. Life insurance is included if owned by the deceased and in some circumstances if owned by a corporation he controlled. However, life insurance is not included, unless under the gift provisions, if owned by a spouse or child of the deceased or by a trust created in his lifetime for their benefit. The interest of a spouse in a community of property is not taken into account.

The Estate Tax Act came into effect on January 1, 1959. At that time it replaced the Dominion Succession Duty Act which had been in force since 1941. The rates of tax imposed under the latter Act, unlike those under the present Act, depended in part on the value of the amounts passing to each successor.

Appraisal of Present System

Having regard to our concept of the comprehensive tax base, we find the present system illogical, inequitable, and inadequate for a number of reasons.

The gift tax and the estate tax are not integrated, except to the extent necessary to grant relief from the imposition of both taxes on the same gift. The calculation of the taxable amount and the rate structure of one bear no resemblance to those of the other. For example, the gift tax is not included in the gift tax base, while the estate tax is payable out of the amount on which it is calculated. Likewise, neither of them is integrated to any significant extent with the income tax. The Estate Tax Act specifically provides 4/ that in determining the value of any property no allowance or deduction shall be made on account of income tax 5/. However, despite certain provisions which deal with specific anomalies, the income tax, the gift tax, and the estate tax each operates on its own. They are not based on any common rationale. We think that because they all deal with accretions

to wealth and acquisitions of economic power by individuals, their subject matters should all be dealt with in a consistent way through one integrated system of taxation.

The gift tax is largely ineffective, except to inhibit the making of very large gifts which might otherwise be made in order to avoid the impact of the estate tax and provincial succession duties. In addition to the once-in-a-lifetime exemption, the gift tax is subject to fairly substantial annual exemptions. Because the amount of the principal annual exemption depends upon the taxable income of the donor for the preceding year, those with the greatest means can make the largest donations without incurring gift tax. In these circumstances most taxpayers keep their gifts within the exemptions and seldom is gift tax paid 6/. Because the exemptions are available each year, a taxpayer can arrange through a programme of gifts extending over several years to make very substantial gifts without incurring gift tax.

It is our considered opinion that an equitable and effective tax system can only be achieved by abolishing the estate tax and the gift tax, and by treating gifts as income of the recipients. In this way the tax liability of each person will be determined by his ability to pay and all receipts will be taxed in a neutral and equitable manner. Our proposals for doing this are outlined below.

The witnesses before us generally recommended the abolition of estate taxes, supporting the recommendation by referring to its relatively low yield, or they asked for an extended time period to realize on assets, and alternative dates of valuation. The comprehensive tax base we recommend in this Report makes it clear that we find no difference between capacity to pay taxes resulting from different forms of economic gain; gifts and legacies under our concept are equally as taxable as recurring income, such as wages and salaries. We believe that our recommendations as to averaging of income, alternative dates for valuation, and deferred payment of taxes, together with a reduced top marginal rate of personal tax, provides as equitable a system of taxation

of estates as can be achieved. In addition, our proposals for the family unit will relieve the widow of having to pay any tax at all on the transfer of property from her husband, a result that should end concern as to the impact of estate taxes upon the surviving members of the family unit.

The argument that the revenue derived from the taxation of gifts and bequests is insignificant warrants specific comment. Certainly the federal collections in 1964 of just under $150 million (before provincial tax credits and abatements) are not substantial when compared to the total revenues of the federal government. However, in assessing materiality of revenue it is probably more significant to examine what the alternative sources of the revenue would be. If personal income taxes were to be increased by a flat percentage amount sufficient to raise the equivalent amount of revenue that is now raised from the gift and estate taxes, individual income taxes would have been increased in 1964 by over 5 per cent. However, it is more likely that it would not be considered reasonable to offset the loss of estate and gift tax revenue by tax increases bearing on the lower income groups. If, as a consequence, the tax increase applied only to persons with income over $5,000, the personal taxes of such persons would have to be increased on average by about 7 per cent and the upper income groups would face tax increases of over 10 per cent. Tax increases of this magnitude are obviously not immaterial, and we do not believe that most Canadians would find them to be an acceptable alternative to the present estate and gift taxes.

In appraising the present system, it is also useful to compare the level of estate taxes in Canada to those applicable in the United Kingdom and the United States. Table 17-1 indicates, for estates of certain sizes, what the tax impact is in each jurisdiction. The figures for Canada and the United States are to some extent understated, as non-creditable provincial and state taxes are not taken into consideration.

TABLE 17-1

ESTATE TAX AS A PERCENTAGE OF TOTAL TAXABLE ESTATE a/
IN CANADA, UNITED KINGDOM AND UNITED STATES

Size of Estate (in '000)			Canada		United Kingdom	United States	
$ Can.	£U.K.	$ U.S.	(a) b/	(b) c/		(a) b/	(b) c/
30	10	28	--	--	4	--	--
60	20	56	4.3	--	12	--	--
120	40	112	12.2	5.2	24	6.7	--
180	60	168	15.9	10.6	35	13.8	1.3
300	100	280	20.3	18.4	45	20.3	5.4
900	300	840	30.2	28.4	60	29.1	12.0
1,500	500	1,400	36.3	35.0	65	32.9	13.9
3,000	1,000	2,800	44.5	42.8	75	40.2	16.5
6,000	2,000	5,600	49.2	48.9	80	50.5	20.1
15,000	5,000	14,000	52.1	51.9	80	65.2	27.1

a/ Before the deduction of any basic or survivor exemptions.

b/ It is assumed that no marital, child or dependant deduction is available.

c/ It is assumed that the maximum deduction for relationship is available in the United States and that in Canada, the deceased (a man) left a widow and two dependent children.

Source: Estate and Gift Taxation (ed. G. S. A. Wheatcroft; Sweet & Maxwell, 1965), pages 108 and 109.

It is evident that the present level of estate tax in Canada is substantially less than that applicable in the United Kingdom, but, except for very large estates, is greater than that applicable in the United States. In particular, the United States tax is substantially lower on that portion of the estate passing to the widow.

Effect of Estate Tax on
Sales of Businesses

Many witnesses before the Commission made reference to the impact of estate taxes on the sale of private businesses, particularly sales to non-residents 7/. In questioning these witnesses, we examined their statements carefully to appraise the seriousness of the charge and to determine whether or not such sales appeared to have unfavourable economic consequences. Most witnesses very quickly stated that taxation would not, by itself, direct business assets to non-resident purchasers, but would cause them to be placed on the market and because of circumstances apart from taxation they might be purchased by non-residents. Some witnesses undertook to conduct further enquiry into this matter and to furnish us, on a confidential basis, with any facts adduced concerning the enforced sale of family businesses. Although some material was, as a result, supplied to the Commission, it did not lead to any clear conclusions. We made enquiries into the more conspicuous incidents which have appeared in the press. In none of these cases did the impact of estate taxes seem to have even a minor influence in favour of sale.

Despite our inability to find support for this alleged unfortunate incidence of estate taxes, it appears reasonable to conclude that taxation imposed on the value of a business will in some instances influence the owner to sell part, or all, of the business. It is highly unlikely that sales of businesses will result from one motive only, and if estate tax is a contributing factor its impact will vary in each instance. However, assuming the extreme position where a business is sold only to meet taxes, the result of the sale may in economic terms be good or bad depending on whether or not it advances the future prospects of the company. There is little

evidence to support the position that businesses tend to prosper to a greater extent because they remain in the same family.

It is not the purpose of the tax system to cause businesses to be sold or to protect them from sale. Taxation should be levied in the most neutral manner possible. However, this does not mean that if a taxpayer elects to place his resources in such a way that they are not readily realizable, he should secure a tax preference over other taxpayers with liquid assets. The tax system should, of course, provide for an orderly realization subject to the securing of debts to the Crown and the payment of appropriate interest. As long as tax can be readily computed there seems little excuse for the failure by taxpayers to make provision for such taxes as will apply to their estates.

THE PROPOSED SYSTEM

Proposal in Outline

Under the concept of a comprehensive tax base and a tax determined by ability to pay, the present gift taxes and estate taxes would be eliminated and gifts received from another tax unit would form part of the income of the tax unit receiving them. Gifts are by definition transfers of value for which no (or inadequate) payment or consideration is given. They include gifts made between living persons, that is, gifts <u>inter vivos</u>, and the passing of property on the death of the donor, that is, testamentary gifts or inheritances.

We also propose that where property has been given, either on death or during the lifetime of the donor, this should in general amount to a disposal of the property by the donor at its fair market value. Thus, any accrued property gain would be realized and would become taxable to the donor. However, a transfer to a member of the donor's family unit should be specifically excluded from being a disposition for tax purposes. This treatment would ensure that property gains, whether realized or unrealized, would be taxed not later than the date on which the family unit was terminated.

It will also prevent the inequity that would arise if one person could give away property to a person who was not a member of his tax unit on which full tax had not been paid, because of an accrued gain, while another could only give away after-tax income 8/. This subject is discussed in Chapter 15.

One of the important features of our proposals is that property accumulated in a family unit should be freely transferable within that unit. In this way the estate which had been built up by a family unit could be used without restriction to support members of the family unit as long as it existed. This treatment would be applicable whether the transfer was made during the lifetime of the donor or on his death. However, a dependent child withdrawing from a unit would be required to include in his income, subject to a $5,000 lifetime exemption, the market value of property taken from the unit. This would be necessary so that if a dependent child received gifts from his parents in excess of that needed for consumption, the excess would be treated in the same way as gifts received by him after he has ceased to be a dependant. This proposal is dealt with in more detail in Chapter 10.

One of the main reasons why people build up estates is to protect their families. The popularity of life insurance attests to this. The desirability of giving further relief to dependants of deceased heads of households was stressed constantly in briefs presented to the Commission. We agree with this objective and meet it with our recommendation concerning the family unit.

We also propose that each person should be entitled to certain exemptions, mainly for the sake of administrative simplicity. These would include the lifetime exemption of $5,000 for gifts received. In addition, we suggest annual exemptions of $250 for a person filing as a single individual, $250 for each spouse in a family unit, and $100 for each child in a family unit. Because of these exemptions it would be expected that most people will never pay any tax on gifts.

In many cases gifts will not be made directly to the donee but will be transferred so as to be held in trust. This may be either an inter vivos trust or a trust arising on death under the terms of a will. We do not regard a trust as a donee but rather as an intermediary. If the beneficiary

of all the income from a trust or the prospective beneficiary of the corpus of the trust were a member of the family unit of the donor, the trust would receive the gift free of tax as if the gift had been made directly to the beneficiary. In other cases the trust would be subject to an initial tax on the gift in order to prevent avoidance or deferment of the tax. When the beneficiary eventually received the trust property he would include it in his income on a grossed-up basis and would receive credit for the initial tax paid by the trust. This proposal is discussed in detail in Chapter 21.

Gifts That Should be Included in the Comprehensive Tax Base

We recommend that all property received from another tax unit by way of gift should be included in the tax base of the recipient. For this purpose the term "gift" should have an extended meaning and should include the following:

1. Gifts *inter vivos*.
2. Transfers of property for inadequate consideration, unless the transfer price was reached as a result of bona fide arm's length bargaining.
3. An extinguishment of debt, including non-enforcement by reason of limitation provisions, or the creation of an "artificial" debt, that is, where the parties were not dealing at arm's length and satisfactory terms of repayment had not been arranged 9/.
4. Successions to property under intestate succession laws.
5. Succession under a will.
6. Receipt of property pursuant to laws for the relief of dependants.
7. Property accruing to the taxpayer by survivorship.
8. Receipt of a power of encroachment or a power of appointment which would permit the property to be used by or appointed to the taxpayer for his own use during his lifetime.
9. Receipt of property as a result of the exercise of a power of appointment.

Inter Vivos Gifts

When property is received by way of gift, it means that the recipient obtains the property free and does not pay or give anything of economic value in return for the property. There are other legal conditions of making an effective gift. The gift must be accepted, and in the case of chattels delivery must be made. Gifts may also be made by written instrument under seal. In this respect we recommend that there should be no special definition of gift, so that the meaning of a completed gift would continue to be that declared by the courts from time to time.

In order that there be a gift there must be a donor. Consequently some pure windfall gains, such as found money or property or gambling gains, would not come within the definition but would be included in the tax base as windfalls. Gambling gains and losses are discussed in Chapter 18. The value of property received without consideration would therefore be included in the tax base regardless of how the property was obtained.

Transfers For Inadequate Consideration

Pure gifts create no special problems, but it is easy to disguise a gift as a sale or other transfer where some payment or consideration is given in return. To take an extreme example, a father might "sell" his new car worth $4,000 to his son (over 21) for $1. Legally this is a sale, but for the purposes of taxation it is the equivalent of a gift of $3,999. It is easy to see the principle in an extreme example but it is not so easy to apply it in practice. Under the Estate Tax Act and the provincial succession duty acts such cases are treated as gifts or dispositions for "inadequate consideration", and the difference between the value transferred and the value received is taxed as a gift if made within the dutiable period. The benefit may also be subject to gift tax under the Income Tax Act 10/.

The present inadequate consideration provisions in the Estate Tax Act are broad enough to include the case in which a stranger buys property at a

bargain price within 3 years of the seller's death 11/. Where bargaining has been at arm's length, such sales are not the equivalent of gifts and we understand that in practice assessments are not made. However, we do not think that a gift should escape tax by payment of a nominal consideration merely because the donor and donee are not related. We recommend that gifts should be defined to include all transfers for inadequate consideration, unless it can be established that the transfer price was reached as a result of bona fide bargaining at arm's length.

There would be some circumstances in which a transfer for inadequate consideration should not be treated as a gift. A transfer of property on the incorporation of a proprietorship, or on a corporate reorganization, may take place at other than market value. This is dealt with in Chapter 15 where we recommend that in some circumstances these transfers be deemed not to be realizations and therefore not gifts.

Powers of Appointment and Encroachment

In some cases an individual is given a power under a will or trust instrument to encroach on property for his own benefit or to appoint the property to himself or others. The power of appointment may be exercisable either during his lifetime by deed or on his death by will, and it may be either special or general. A general power is exercisable in favour of any person without restriction, while a special power can be exercised only in favour of one or more members of a limited group or class of possible beneficiaries.

Where the terms of a power are such that the person having the power can appoint the property to himself or otherwise acquire it for his own benefit during his lifetime, the property is at his disposal. In these circumstances, the property should be included in his tax base when the power becomes exercisable as if it had been given to him outright. However, we recommend that if he renounced the power within a period of 90 days after he became aware of it or after it became exercisable, whichever was later,

the property which was subject to the power should not be included in his tax base. This would be consistent with the legal position in relation to ordinary gifts, that a gift is not complete unless accepted by the intended donee.

There are various types of power that we recommend should not result in the subject property being included in the tax base of the person having the power. These are cases in which that person is not entitled to use the property himself, but is instead in a position similar to that of a trustee with discretionary powers. For example, if a person had a power of encroachment which could not be exercised without the concurrence of some other person, the property would not be at his disposal and should not be included in his tax base unless or until the power is exercised. If a power of appointment, whether general or special, were subject to a restriction which prevented an appointment in favour of the person having the power, the property would not be available for his personal use and should not be included in his income. If a general power of appointment is exercisable only by will, it would not be possible for the grantee of the power to exercise it in his own favour during his lifetime, and accordingly it should not be included in his tax base. It is our view that the legislation should not distinguish specifically between general and special powers of appointment, but should provide in a general rule that if a person is granted a power which he did not renounce within a stipulated period and under which he would be entitled on the exercise of the power to acquire property for his own use, the property would be regarded as having been given to him.

Property transferred to a beneficiary on the exercise of a power of appointment should be included in the beneficiary's tax base as a gift. This should be the case whether or not the property has been included in the tax base of the appointer under the rule outlined above. If it had been included in his tax base because it was available to him for his own use, his position would be similar to that of a person who had actually received property by way of gift and then had given it to another.

Conditional Gifts

A further problem arises where, although there is no direct consideration for a transfer of property, it is conditional on the transferee's doing some collateral act. For example, a father might transfer to his adult son a farm having a fair market value of $15,000, on condition that the son pay $10,000 to his sister, who is also adult and thus outside the family unit. If parties to such a transaction had been dealing at arm's length, the transferee of the farm would pay no tax if he could establish a bona fide transaction. The sister would pay tax on the $10,000 she received. Because the father and son would not be dealing at arm's length, the son should be taxed on $5,000, the difference between the consideration given and the fair market value of the property. In other words, the cost to the transferee of complying with the condition should be treated as an expense of acquiring the gift.

An essentially similar case arises where the condition for receipt of a gift is the payment by the donee of an annuity to another person. The courts have decided these cases on the basis of whether the annuity was charged on or directly connected with the transfer of the property. We recommend that conditional gifts should be recognized as such where their conditional nature is clear, whether or not there is a legal charge on the property, and that only the net proceeds be taxed to the donee.

Meaning of "Property"

We have concluded that the acquisition of anything which adds to a person's economic power should be included in his tax base. This means that the concept of "property" should be all-inclusive. Definitions similar to those now in the Income Tax Act and the Estate Tax Act would appear to be satisfactory. For example, the Estate Tax Act provides that

> "'property' means property of every description whatever, whether real or personal, movable or immovable, or corporeal or incorporeal, and without restricting the generality of the foregoing, includes any estate or interest in any such property, a right of any kind whatever and a chose in action;...." 12/

The definition of property includes partial interests in property. A common division of interests is to give one person an interest in the income of a fund, for example, an interest during his lifetime, and another person an interest in the capital on the death of the first person. The ability to divide property into lesser interests causes some difficult problems. We propose that where property had been given in trust it should only be required to be included in the tax base of a beneficiary when he becomes entitled to receive it or other property from the trust. In order to prevent avoidance or deferment of tax, the trust should be subject to an initial tax for which the beneficiary would receive credit. The treatment of trusts is discussed in Chapter 21. Where a person received a gift of a property interest which was not held in trust, such as an undivided interest in real estate, it would be included in his tax base immediately upon the interest vesting in him.

Ordinarily, a person with the legal title to property is also the beneficial owner. However, property is sometimes conveyed to one person as nominee for another. Such a nominee may be a bare trustee or he may be holding the property to ensure fulfilment of a condition by the beneficial owner. In either case the beneficial ownership of the property rather than the legal title should be considered for tax purposes. A person who acquired the beneficial ownership of an interest in property by way of gift should include in his tax base the value of that interest. On the other hand, a person who acquired the legal title to property but no beneficial interest should not be subject to tax in his personal capacity. As already indicated, if he was a trustee he may be required to pay an initial tax out of the trust funds.

If property is loaned to another, the right to use that property, for example, a car, is a valuable right. We recommend that such property should not be included in the tax base of the borrower, because it would not be owned by him, and he would be under an obligation to return it. However, if he had a legal right to use it without consideration, the rental value

of the property in each year should be treated as a gift to him. If he had a legal right to obtain services without consideration, the value of the services should likewise be treated as a gift.

Similarly, if a trust or will permitted a beneficiary to use property without payment of a reasonable rent, the rental value should be included in his income. This is presently provided for by section 65 of the Income Tax Act, and we recommend that this or a similar provision be retained 13/.

"Net" Property Received

Because we are proposing that taxes be based on ability to pay, it follows necessarily that only the "net" value of property should be taxed. For example, if a father gave to a son land worth $20,000 which had an unpaid mortgage of $5,000, the taxable value of the property would be $15,000.

When an individual dies, his estate may be liable for tax, either as a result of deemed realization of appreciated property at his death or otherwise. This tax liability would be deducted in arriving at the amount of gifts to his beneficiaries. Each of them would be taxed only on the net value actually received.

This concept also means that reasonable costs of administration and any losses incurred in the course of administration would be excluded from the net receipt by a beneficiary. The expenses and losses in administration are not, strictly speaking, allowed as deductions to the donee. The amounts are never received and thus should not be taxable to him. There is a primary control on the reasonableness of expenses, because the expenses of executors and administrators are subject to review by the court on the audit of their accounts.

Meaning of "Receipt"

The term "receipt" assumes that there has been a transfer of title to or beneficial ownership of the property. Ordinarily, a gift is completed

and received when there has been a complete transfer of legal title and possession to the donee. Possession by an agent, nominee or bare trustee for the donee would be the equivalent of possession by the donee.

A prospective donee cannot renounce a gift after it has been completed. Completion of the gift requires acceptance by the donee, and in order to render the proposed gift ineffective the donee must not accept it but should renounce the gift as soon as possible after he receives knowledge of it. We recommend that provision should be made that renunciation would not be effective for the purposes of the taxing act unless made within, say, 90 days of the time when the prospective donee received knowledge of the gift.

Where there was no legal transfer of property, but a property owner conferred on another person a right or benefit that was less than beneficial ownership of an interest in property, the other person should not be treated as a donee of the property, but should be regarded as having received a gift equal to the value of the benefit received. Similarly, if an individual took one or more steps which did not involve a transfer of property but resulted in his property becoming less valuable, while the property of another person increased in value, the individual would have conferred a benefit on the other person which should be included in the tax base of the latter. This would occur, for example, if a father owned shares of one class in a company while his son owned shares of another class and transactions were carried out which had the effect of decreasing the value of the father's shares and increasing the value of the son's shares. This type of transaction could be dealt with by a provision to the effect that, if as a result of one or more transactions one person conferred a benefit on another, he would be regarded as having made a payment to the other 14/. It should also be provided that, if the value of any property owned by the person conferring the benefit was reduced by any such transaction or transactions, the cost basis of the property to him would be reduced by that amount.

Consideration should also be given to the situation which would arise where a donor transferred property to a donee, but reserved a right or benefit to himself. Understandably, administrations in Canada, the United States and the United Kingdom have exercised considerable ingenuity in making these gifts subject to estate tax 15/. Typical examples of this would be the transfer of a farm with a reservation of the right to reside and be maintained thereon, a transfer of a business with an annuity reserved out of the profits, or a transfer of property in trust on terms which reserved a reversionary interest to the settlor 16/.

The taxation of the family as a unit under our proposals would reduce the incentive for these arrangements, for there would be no tax on the transfer to a wife or dependent children and the income from property would be taxed in the family unit in any event. Nevertheless, there may remain an area where it would be to the donor's advantage to transfer rights of immediate enjoyment in the property to the donee, but retain a "string" by which he could recover the property or obtain a benefit from it. We have concluded that, in the light of our proposed system of taxing donees, the problems in this area could be satisfactorily dealt with (assuming the property is not held in trust) by the two following rules:

1. Where a donee has received an immediate property interest which could be valued, it should be valued and tax paid on the transfer notwithstanding that the donor has retained a benefit. This would apply to interests in property for a term of years with a reversion to the donor.

2. Where the interest retained by the donor takes effect only on the failure of the gift or where it is of uncertain value, the donee should be taxed on the full value of the property transferred. However, if the property was reacquired by the donor, the donee should be entitled to claim a property loss equal to the value of the property at the time it was so reacquired.

The foregoing would apply only where the benefit or interest retained by the donor may benefit him or his estate. Where the donor retained a lesser power, such as a power to alter beneficiaries, accumulate income, distribute income among named beneficiaries, or encroach on principal for the benefit of income beneficiaries, the principles set out in Chapter 21 would apply.

Tax-Paid Gifts

Many wills now provide that certain gifts to individuals are to be tax free; that is, that taxes are to be paid out of the estate and thus are to be borne by someone else, such as the beneficiary of the residue of the estate. Under our proposals, the payment of tax out of one beneficiary's share on behalf of another beneficiary would increase the benefited person's taxable capacity to the extent of the amount so paid. It would thus be necessary to impute as additional income of a recipient taxes paid on his behalf by the executors out of the estate. The amount of income to be imputed would depend on the tax payable, which in turn would depend on the original gift plus the amount of the tax which was imputed as an additional gift. This leads to a series of gifts of tax on tax. The sum of this series can be readily calculated by the use of a mathematical formula. This leads to complications when the result puts the beneficiary in a higher tax bracket, but the correct answer can be obtained by the application of an adjusted formula 17/. This is much simpler than the present method used by the Estate Tax Division of the Department of National Revenue, which has recently been upheld by the Supreme Court of Canada, 18/ and we recommend that such a formula should be used.

Gifts to Corporations

We propose that gifts to corporations should be taxable at full corporate rates. There is no reason in principle to exempt ordinary corporations from the tax on gifts, and in practice the exemption of corporations might permit tax avoidance. If a gift to a corporation were tax free, the amounts

given could then be returned to shareholders by redemption of shares or in some other manner without tax liability. Thus, gifts could be made indirectly from one individual to another without immediate tax. For this reason we recommend that, in general, gifts should be taxable when received by corporations.

It is necessary to provide for certain exceptions to this general rule. For example, where an individual had been carrying on business as a proprietor he should be entitled to transfer the assets of the business to a corporation whose shares he owned at the book value rather than the fair market value. There may be other circumstances in which it would be desirable for the shareholders to make a capital contribution to a corporation. This might be accomplished by a transfer of funds or other property to the corporation without consideration or for a consideration less than the fair market value. It might also be accomplished, in effect, by a subscription for shares at more than their fair market value. However, exceptions to the general rule should be strictly limited so that they would not be open to abuse. Accordingly, we are prepared to recommend exclusion of gifts received by a corporation only if they are made by a shareholder who had a 100 per cent interest in the corporation, or by all the shareholders pro rata in accordance with their shareholdings. This exception should apply only where the corporation had only one class of shares outstanding or where the shares of each class are held by the same shareholders in the same proportions at the time of the gift. This is discussed further in Chapter 15.

Gifts in Instalments

Gifts which are paid immediately present no major problems respecting the proper time of valuation or time of payment of tax. However, gifts which are paid in instalments over a period of time raise these problems, particularly the problem of whether the gifts should be taxed when the right to receive them arises at their present value or as they are received. We recommend the taxation of the present value of future enforceable rights

obtained by way of gift, but in Appendix F to this Volume, we outline an alternative method of taxing instalment gifts as received.

A gift may be made in instalments in a variety of circumstances. If the donor retains the property and does not enter into a binding commitment with the donee to pay the future instalments, there will be a completed gift only as each instalment is paid. In this case the instalment would be valued and included in the tax base of the donee at the time of each transfer or payment.

If the donor enters into a binding agreement under which he is committed to make future payments, the donee will have acquired valuable rights at the time of the agreement. The same will be true if the donor has made an arrangement under which some third party has become obligated to make future instalment payments to the donee, provided the donee is entitled to enforce payment.

In either of the above cases it would seem reasonable that the total gift should be included in the donee's tax base at the time he acquired valuable rights. However, if there were some possibility of non-payment, and particularly if the donee could not collect, then the donee should be entitled to deduct a provision for risk of non-payment. It might also be provided that the donee would be entitled to pay the tax by instalments with interest, on the ground that the amount included in income was not liquid.

If a gift were paid into a trust with provision for payments to a beneficiary in instalments over a period of time, the trustee would be subject to an initial tax on the value of the gift, and the beneficiary would include the instalment payments in his tax base as they were received. In computing his income the payments would be grossed-up to include the initial tax on the gift, and he would receive credit for the initial tax. This is discussed in Chapter 21.

Annuities

One widely used form of gift is the annuity 19/. A donor during his lifetime may purchase an annuity which is payable to another (the donee). Alternatively, he may direct his executors or trustees to pay an annual amount to a specified person after his death. In either case the annuity would normally be payable during the lifetime of the donee and the total amount to be paid to the donee would depend upon how long he lived. Where the annuity is purchased from an insurer, its cost, which may be regarded as its present value at the time of purchase, is based primarily upon the annuitant's expectation of life as determined from mortality tables 20/.

Because an annuity has a present value, it is a form of property which can be bought and sold. This feature can be changed by a provision to the effect that it will be non-assignable and non-commutable. Such a provision will effectively prevent the beneficiary from realizing on its value in advance of the contractual times of payment.

When an annuity is established a sum is normally paid or set aside to provide for its payment. This sum will earn interest while invested by the insurer or the trust providing the annuity. Each payment to the annuitant can be regarded as partly a return of the amount paid in and partly income from the investment of that sum.

Where an annuity has been purchased under a Registered Retirement Income Plan the annuity payments should be included in the income of the recipient in full when received, because the contributions made to provide the annuity will have been deducted in computing the contributor's income when made. The treatment of such a plan is discussed in Chapter 16. That chapter also deals with the case in which an individual purchases an annuity for himself or a member of his family unit or both as joint annuitants under a non-registered plan. In this latter case the income element of the annuity would be subject to tax as it arises, and the capital element, representing a return of contributions which were non-deductible, would be tax free.

The subsequent discussion of annuities in this chapter will relate only to the case in which an annuity is provided by a donor for a donee who is not a member of his family unit. Such cases will probably be a small proportion of all annuities.

Where the person who purchased or provided the annuity was not himself the annuitant or a member of the annuitant's family unit, the annuity would be a gift, the amount of which would be included in the donee's income and taxed. The principal question is at what time and at what rate should the tax be levied.

Where an annuity was payable under the terms of a will on an *inter vivos* trust, it should be dealt with in a manner consistent with other payments out of trusts. Because of the complexities of trusts, the mechanics of taxing such annuities would be different than for contractual annuities, but in most cases the overall effect would be similar.

The recommended procedure for taxing annuities payable under a will or trust is dealt with fully in Chapter 21, but the proposed treatment may usefully be summarized here. Such an annuity may be payable entirely out of trust income or partly out of income and partly out of corpus. Assuming that the beneficiary was not a member of the family unit of the donor, the trust would pay an initial tax on the gift of corpus when it was received. The trust would also pay an initial tax on trust income as it arose. In many cases the trustee would have the option of paying the initial tax at a rate which would be applicable if the beneficiary had received it. The beneficiary would then include in his tax base the full amount of each annuity payment as it was received. This would be grossed-up to include the initial tax paid by the trust on both the corpus and the income from which the distribution was made, and the beneficiary would receive credit for that initial tax. To the extent that the annuity was payable out of the current income of the trust, the beneficiary would be entitled to elect that no initial tax be payable but that the income distributed be included in his income.

Where an annuity was purchased by one person for another from an insurer, there are two principal alternative methods of dealing with it in the proposed tax system. One would be to tax each annuity payment as it was received without distinguishing between the capital and income elements. The other, which we recommend, would be to include in the donee's tax base the amount required to purchase the annuity, and then to tax the interest or income element each year as it was accumulated by the insurer. There would then be no tax on the annuity payments unless and until they aggregated more than the amounts previously included in income.

One of the principal considerations is to maintain neutrality among different kinds of gift and other types of income. For example, if a donor were to make a gift of cash with which the donee purchased an annuity, the value of the gift would be included in the donee's tax base immediately. The income element would then be subject to tax as it arose. However, if the donor had purchased an annuity for the donee, and if the annuity payments were included in the donee's income only when received, there would be a deferment of tax. Such a deferment should be prevented to the extent possible.

On the other hand, if a donee were to receive a cash gift, he would have immediate control over the subject matter of the gift, and would be free to invest it or deal with it in any manner he wished. A donee of an annuity would often not have this choice if the annuity were non-commutable or if it could only be commuted for an amount substantially less than its present value. If the annuitant were required to pay tax immediately on the present value of the annuity, this could create a hardship because this value might be very high and the tax would exceed the amount of annuity he would have received when the tax became payable. The nature of the gift would be such that he could not place it in a deposit account so as to defer tax. However, he could qualify it as a Registered Retirement Income Plan in the same way that any other property could be transferred to such a plan, and thus would be able to defer the tax liability. To the extent that there remained an amount that was not eligible for a Registered Retirement Income Plan and therefore had to be included in income, the liquidity problem could be reduced if provision were made for payment of the tax over a

was not in fact received, the shortfall would be a property loss which could be deducted from other income, and in this way provide, in effect, a refund of the taxes paid. It may be necessary to have a special backward averaging provision which would be applicable where a loss on an annuity occurred at death, because the proposed five-year provision may not be adequate.

For these reasons we recommend that an annuity contract which was the subject of a gift should, in the first instance, be included in income in the year the gift was made at its present value at that time. The subsequent investment earnings should be included in income each year as earned, just as we recommend in Chapter 16 for all non-registered retirement plans. The annuity payments would then be free of tax as a return of investment, with any difference between the total amount received and the cost basis, that is, original gift plus investment earnings included in income, being included in income as a gain or loss. This treatment would tax the donee in the same way as if he had received a cash gift and had himself purchased the annuity. If the donee qualified the annuity as a Registered Retirement Income Plan, then no tax would be payable at the time of gift or when the investment income was earned, but rather the payments would be included in income when received. We would expect that this latter option would be employed, for example, by parents or other dependants of the deceased who received a bequest in this form to ensure that they had the funds available for their continued maintenance. In this way the beneficiary would only pay tax when the annual benefits were received.

As in the case of other proposals in this Report, we do not intend the recommended treatment of annuities to be retroactive. Accordingly, if an annuity had been given prior to the effective date, the present gift tax or estate tax provisions would have been applicable, and the capital element of the annuity should not be included in the tax base of the recipient. The income element will have been taxable under the present provisions before the effective date, and would be taxable under the proposed provisions after the effective date.

Gifts Involving Proceeds of
Insurance and Pension Plans

This rather similar group of payments can be considered as a whole. It includes pension payments, death benefit payments, benefits from profit sharing plans, deferred profit sharing plans, supplementary unemployment insurance plans and payments under life insurance policies.

We are not concerned here with the payments made to the employee, the contributor, or the policyholder. We discuss the treatment of benefits paid to these persons in Chapter 16. In this chapter we are concerned only with a person who receives such benefits and who was not himself the original employee, member, or contributor who caused the benefits to accrue. For such a person the benefits received would be a gift as we have defined it and should be taxed accordingly.

By far the largest group of beneficiaries would doubtless be the wives and dependent children of the contributors. Generally speaking, these beneficiaries would include in their incomes such amounts as would have been included in the deceased's income if he had received them. Death benefits and similar payments from an employer on which the deceased had not paid tax would be included in the income of a member of a family unit who received them. This would also be true in the case of payments from a Registered Retirement Income Plan. One of the requirements of registration is that benefits must be payable to the contributor or to a member of his family. Thus, payments would have to be included in the income of the family or the estate of a deceased member. However, where payments have been made into a non-registered plan which had been purchased by the deceased out of tax-paid income, these payments would be free of tax on being returned to a member of his family unit. The income arising under such a plan would be taxable to the beneficiary to the same extent as if the deceased were receiving the payments. The proceeds of life insurance policies, other than group life insurance, purchased by one member of a family unit would be excluded from income when received by any other member of that unit in the same way as if

they had been received by the person paying the premiums, at least in the initial period where mortality gains and losses on such policies would not be taken into account. Thus, the benefits received on cancellation, maturity, or death would be excluded from taxable income.

If payments of this kind were made to a person who was not a member of the deceased's family unit, they should be treated as gifts and included in the recipient's tax base. If the payments were made under a non-registered retirement income plan and were payable during the lifetime of the donee, they would be treated as annuities. If payment were made in a lump sum, it would be included in the donee's income and taxed at his personal rate. The proceeds of a life insurance policy owned by a taxpayer but payable to a beneficiary outside his family unit would also be included in the beneficiary's income, either as a lump sum or at an arbitrary valuation if the benefits were in the form of an annuity. In all cases the amount of tax liability would be subject to such elections as the donee may make with respect to averaging, payments of tax by instalments, or payment of all or part of the amount received into a Registered Retirement Income Plan.

Exemptions

The exemptions contained in the present gift and estate tax legislation can be divided into the following types:

1. Gifts to exempt persons and institutions, such as charities and government bodies.

2. Deductions of specified amounts permitted, regardless of the identity of donor or recipient, such as the $40,000 basic deduction under the Estate Tax Act and the $4,000 minimum under the gift tax provisions.

3. Deductions made to simplify administration, such as those under the Estate Tax Act for gifts made by the deceased as part of his ordinary and normal expenditure, and under the gift tax provisions of gifts up to $1,000.

4. Deductions dependent on the existence of family relationships, such as the estate tax deductions for spouse and dependent children, and the gift tax deductions for the once-in-a-lifetime gift of an interest in real property.

Whether a tax is imposed upon the donor or the donee, reliefs such as those listed above are usually given by way of a deduction from the tax base. There may be no tax at all if the donee is exempted from taxation. Gifts to charitable organizations, which are exempt under section 112 (4)(c) of the Income Tax Act, would not be subject to gift tax.

Under our proposal, transfers of wealth among members of a family unit, either during the lifetime of the transferor or on his death, would not be subject to taxation. This would reduce the need for specific exemptions. However, we propose certain exemptions partly based on social grounds and partly designed to relieve administrative problems.

The present exemptions from estate and gift taxes would, of course, no longer apply, since those taxes would be abolished, and gifts and inheritances would be taxed in the hands of the donee.

Apart from gifts from members of the family, individuals generally receive gifts from relatives and close friends on special occasions such as Christmas, birthdays and marriage. To include all such gifts, large or small, in the recipient's tax base would cause general taxpayer inconvenience, and would lay a burden on the administration out of proportion to the value of the resulting revenue. However, the higher the annual exemptions, the greater the possibilities of tax-free gifts which, if made systematically, could aggregate considerable amounts. High annual exemptions benefit the wealthy more than others. Thus, a wealthy person could make full use of the annual exemptions by giving the maximum amounts each year.

Under the present gift tax provisions, gifts of under $1,000 to any one individual in a year are not included in the taxable base. This has two effects. First, a donor may make several gifts of under $1,000 to different individuals and in that way give away a substantial amount of money free of gift tax. Second, individuals may receive gifts of under $1,000 from several different donors and thus receive a total amount of far more than $1,000 a year without any tax being paid. Furthermore, such gifts are not included when computing the general exemption of $4,000 or one half the difference between the taxable income of the donor and the tax thereon for the immediately preceding taxation year.

We consider the present levels of exemption from gift tax much too high to be justified on administrative grounds alone. We have considered the level of exemptions which would relieve administrative problems with respect to reporting annual gifts and yet not afford a loophole for tax-free transfers of wealth in substantial amounts. We have concluded that an annual exemption for individuals of $250, for spouses who were members of a family unit of $250 each, and for dependants who were members of a family unit of $100 each, would satisfy these requirements. Transfers between members of the family unit would not enter into the calculation. A family unit would be entitled to aggregate the exemptions of all its members for the purpose of calculating its aggregate annual exemption. Thus, a family unit consisting of two spouses and two children could claim an annual exemption of $700. The annual tax return should have a section dealing with gifts in which all gifts received from outside the unit would have to be reported if their total exceeded in value the amount of the unit's exemption.

We considered the possibility of other deductions on social and administrative grounds and we recommend that in addition to the annual exemptions each individual should be allowed an aggregate lifetime exemption of $5,000. We think it is reasonable that a child who leaves the family unit should have an exemption of this amount to assist him in becoming established. This would eliminate the tax liability that otherwise could have arisen when the child leaving the family took with him his personal

effects. In addition it should suffice to exempt most married couples from tax on their wedding gifts because the couple would be able to aggregate the unused portions of their individual exemptions. The lifetime exemption should apply to gifts in excess of the annual exemption in any year. It should be cumulative and any part of the $5,000 exemption not used in one year would be carried forward to subsequent years. If a child or married couple did not use the full exemption at one time, he or they should not be deprived of it, and should be entitled to the balance of the deduction when it could be used.

We believe that with these proposed exemptions a majority of people would never pay tax on gifts.

Successive Transfers

Strict adherence to the principle of taxation according to ability to pay would not permit a general concession based on the frequency with which gifts inter vivos were made 21/. One would expect that because tax would arise every time property was transferred, transfers would not be made more often than necessary.

It would appear, however, that a concession could justifiably be made where a second transfer was involuntary, as when death occurred, within a short time after the first transfer to the deceased. In this case it could reasonably be assumed that where the deceased was leaving assets to his beneficiaries, he did not have an adequate opportunity to enjoy the use of the property received by him on the first transfer. Accordingly, we propose an exemption for the recipients of gifts arising on death, where the deceased donor had himself paid tax on gifts he received from persons outside his tax unit within four years of the date of his death. The amount of the exemption would be a diminishing percentage of the gifts received by the donor and included in his tax base in each of those four years. This percentage might be 80 per cent of the taxable gifts received by the donor within a year before his death, 60 per cent of such gifts received by him between one and two years

before his death, 40 per cent of such gifts received by him between two and three years before his death, and 20 per cent of such gifts received by him between three and four years before his death. The amount of the gifts on which these percentages would be calculated would be subject to an overall limitation equal to the gifts passing on his death which would otherwise be taxable. The exemption would be allocated among his beneficiaries who were subject to tax in proportion to the amounts received by them on the donor's death.

This exemption would be similar in principle to the present "quick succession" provisions in section 33 of the Estate Tax Act. Under that section it is necessary to identify the property passing on death on which the reduction in value is calculated as property previously subject to tax or property exchanged or substituted therefor. In our view this requirement is likely to cause administrative difficulties both for the Department and the estate in tracing properties and is likely to produce capricious results. It would penalize the estate of the person who had consumed the subject matter of the gift but elected to save other property. Identification would usually be impossible in the case of a gift received in cash or converted into cash which had then been intermingled with other funds in a bank account. For these reasons we recommend that there should not be any such requirement for identification of property, but that the exemption be calculated under a formula such as that referred to above.

Valuation of Property

The general rule under the Estate Tax Act is that the value for tax purposes is the "fair market value" of the property. The same is true under the gift tax provisions, although it is not made explicit. The term is not defined in the statutes but has received considerable judicial consideration. Nichols states:

> "By fair market value is meant the amount of money which a purchaser willing but not obliged to buy the property would pay to an owner willing but not obliged to sell it." 22/

Values arrived at by many different methods may be taken into account: for example, intrinsic value, replacement value, cost, comparative market data, and income-earning capacity of the property.

Generally, fair market value is the accepted test and under the Estate Tax Act, for example, the price of listed shares on a recognized stock exchange is deemed to be fair market value, except in the case referred to below. The Estate Tax Act and some of the provincial succession duty acts recognize the special problems of valuing the shares of companies or other business interests which are not traded publicly, particularly if they are closely held. Under the Estate Tax Act the rule that the listed or quoted price is conclusive does not apply where the deceased by himself, or with others with whom he was connected by blood, marriage or adoption, controlled the enterprise. The value per share of a block of shares sufficient to control an enterprise is often greater than the value of shares which are not part of such a block. In private companies, the value of a minority interest is usually discounted because the market for such an interest is usually very limited. However, a common problem in valuing publicly traded shares is the possible depressing effect on the market if a large number of shares have to be sold within a short period.

One possible solution would be to have special rules which would attempt to deal with all the different types of valuation problem that arise. We have concluded that on the whole it would be better to rely on the standard of fair market value as interpreted by the courts, without any legislative guidelines. The circumstances which may exist are so diverse that almost any conceivable set of rules would be inadequate and in some cases would produce unfair results. We think that legislative provisions tend to become too rigid and hinder effective valuation as much as they promote it, and that the rules developed by the courts provide adequate guidance. However, in recommending this we recognize that the administering authority must develop some policy rules as a guide. We expect they will continue to develop and refine "rules of thumb" dealing with controlling and

minority interests, problems of lack of marketability, and so on. The taxpayer will always, however, have a right of appeal. If the administrative authorities are reasonable in their valuations there should not be an excessive number of valuation appeals.

Time of Valuation,
Receipt and Payment

We have given consideration to the appropriate time for valuation of gifts. Under the present laws inter vivos gifts have generally been valued at the time they were made and gifts arising on death at the time of death. However, there have been special provisions governing the time of valuation of inter vivos gifts which were deemed to be property passing on death. Because under our proposals the donee would be the person subject to tax on gifts, we recommend that the basic time for valuation should be the time of receipt or of constructive receipt by him of the gift. The question then arises whether there should be an alternative date for valuation.

A number of submissions advocating an alternative date for valuation in the case of gifts arising on death were made to the Commission. There is often a delay between the date of death and the distribution of the estate. The normal processing and administration of an estate takes time. If the time of inclusion in the donee's tax base were the time of vesting of the donee's interest (which would often be the date of death), the donee might have to pay tax based on the fair market value at a time well before receiving the gift. However, in Chapter 15 we recommend that revaluations of certain types of property be permitted at the option of the taxpayer. Accordingly, if the value declined before he received the gift he would, generally speaking, be able to claim the decline in the value of his property interest as a loss and would, in effect, obtain a tax refund. Until such time as the optional revaluation procedure became applicable to all property, it should also be provided that any property received by way of bequest or gift would be eligible for revaluation within two years from the date it was included in income. Therefore, the donee would have all the advantages of alternative valuation dates.

There remains the question of when a gift arising on death should be included in the income of the donee or in the income of the trust arising on death. We have suggested this should occur when the gift was received. For this purpose receipt should be deemed to take place at the date of actual or constructive receipt, provided that in any case the gift would be regarded as having been received not later than twenty-four months after the date of death. If the identity of the beneficiary were not known twenty-four months after death, the gift should then be included in the income of the trust arising on death. If the gift was to be held in trust under the terms of a will, it should be included in the income of the trust at the time letters probate or letters of administration were obtained, but in no case later than twenty-four months after the date of death. The treatment of gifts arising on death is dealt with further in Chapter 21.

Gifts inter vivos do not entail the same problems of administration as gifts arising on death. Because such a gift is made voluntarily, the parties would be in a position to foresee, at least to some extent, possible changes in value and the necessity for the availability of funds to pay the tax. For these reasons we recommend that inter vivos gifts should be valued on the date of actual or constructive receipt and should be included in the donee's income in the year in which such receipt occurred.

Gifts consisting of property other than cash or marketable securities merit special treatment as to the time of payment. If the property were not readily salable or must be held for special reasons, as in the case of an interest in a business or an art collection, it may result in hardship to require payment of tax when the gift was received. Such gifts cannot be deposited in an Income Adjustment Account, although they could be put into a Registered Retirement Income Plan if such a plan were not already at its maximum level. If money to pay the tax could not be borrowed on the security of the property, some form of deferment of payment would be warranted. We recommend that the tax in respect of such property be made payable in instalments, with interest, over at least five years, and perhaps ten years

for specific property such as the shares of a private company or an interest in a farm, provided that if the property were realized for cash or marketable securities, the time for payment would be accelerated. This is similar to the present section 16 of the Estate Tax Act, except that under our proposal the taxpayer would be entitled to deferment as of right instead of relying on the Minister's discretion.

While we think our proposal would solve the problem of lack of liquidity to a reasonable extent, we would recommend that this matter be kept under review.

Rate Schedules and Averaging

While the proposed rates applicable to taxable gifts would generally be higher than the present gift or estate tax rates, comparisons between these rates can be misleading 23/.

Of primary importance in any comparison is the exclusion from the recommended tax base of gifts from one member of a family unit to another, including property which passed on death to a surviving spouse. In addition, our proposals entail a number of basic changes which would make it difficult to predict what the changes in tax rates applying to individuals would be or what changes in revenue would take place.

Under our recommendations gifts would be part of the defined tax base. Apart from intra-family gifts, gifts in excess of the exemptions that we propose would normally be taxable to the donee. Tax would be imposed at the donee's rate which would usually be lower than that of the donor. The effective rates would also be reduced in many cases by the application of the averaging provisions we discuss in Chapter 13, or because of the donee's investments in Registered Retirement Income Plans which we discuss in Chapter 16.

Perhaps the best way to appreciate the effect of including gifts in the comprehensive tax base is to look at some examples. Table 17-2 gives a summary of typical tax rates which might apply to gifts from an estate.

TABLE 17-2

EFFECT OF INCLUSION OF GIFTS FROM OUTSIDE THE FAMILY UNIT IN EXCESS OF EXEMPTIONS IN THE COMPREHENSIVE TAX BASE FOR MARRIED COUPLES WITH THREE DEPENDENT CHILDREN a/

Panel A

Annual Income	Average Tax Rate On Annual Income Before Gift	Average Tax Rate on Income, Including Gift After Averaging		
		$25,000 Gift	$100,000 Gift	$250,000 Gift
$6,500	7.1	10.8	16.6	23.9
10,000	12.5	14.3	18.7	25.5
25,000	21.2	22.4	25.5	30.1
		Average Rate of Tax on Gift		
6,500		19.5	22.3	27.9
10,000		21.5	24.9	30.7
25,000		33.9	36.2	38.9

Panel B

Effective Rate of Tax on Gifts Under Present Estate Tax Rates at Selected Levels b/

Net Value of Estate Before Personal Deductions		
$15,000	$75,000	$300,000
nil	7.067%	20.27%

a/ It is assumed that the taxpayer and spouse have already made use of their lifetime exemptions of $5,000 each. If this were not the case then the tax liability would be reduced substantially.

There is deducted from tax the tax credits for family unit and dependants. It is assumed that the wife is not working and that the income level does not change during the averaging period.

To achieve the best averaging result, one half of the gift would be included in the current year's income and form part of a backward five-year block average. The other half would be deposited for one year into an Income Adjustment Account. This latter portion could then be included in the subsequent five-year period so that the gift would be spread over ten years. Although such a procedure entails a loss of some investment income for one year, and although the tax refund from the forward averaging could not be claimed for five years, nevertheless the procedure does effectively result in averaging the gift over ten years.

b/ It is assumed that the deceased has neither a widow nor dependent children, and also that there are no other deductions or credits.

In provinces which have a separate succession duty, the combined estate tax and succession duty could be higher.

The annual income of the donee has no effect on the rate of estate tax.

We have pointed out that it is difficult to compare the impact of our proposals with the present taxation of estates. Table 17-2 illustrates that while small estates are not now subject to tax, our proposals would result in the application of full personal rates to most of any bequest from such an estate passing outside the family unit. Transfers within the family unit, which would be the method of distribution of a substantial proportion of smaller estates, would continue to be free of tax. In the case of larger estates an answer to the question of whether the level of tax would increase or decrease would depend upon the proportion of the total estate that passed to persons outside the deceased's family unit. Table 17-2 indicates that in general the rate of tax would increase substantially if all the estate passed to another family unit. On the other hand, if the whole estate passed to the widow or a dependent child, then no tax would be payable under our proposals. If one assumes that one half of the estate passed outside the family unit and one half to the widow, then the level of tax on transfers from most estates exceeding $250,000 would decline from what would at present apply.

However, it must also be kept in mind that while under the present gift and estate tax laws it is possible to arrange many transfers (even of substantial amounts) that will be subject to little or no gift or estate tax, under the comprehensive tax base all gifts received from outside the family unit would be brought into the income of the donee. One significant item that would, as a result, be included in the income of many beneficiaries would be the proceeds of life insurance policies, only a small proportion of which are now taxable. Thus, although the rate of tax on many gifts may decline, other gifts not now taxed would become subject to tax and therefore the total tax revenues from gifts should increase substantially.

As our proposals mean that the tax on transfers within the family unit would be eliminated, Canada would certainly compare favourably in this regard with the United States and the United Kingdom. On the other hand, the level of Canadian tax on transfers outside the family unit would in general be increased under our proposals so that, except for the very large estates, the Canadian taxes on these transfers would exceed those levied in the United States.

Nevertheless, the Canadian tax on transfers outside the family unit would still be less than that levied in the United Kingdom for most estates of over $200,000.

Gifts To Non-Residents

At the present time, a Canadian resident is subject to gift tax on any gift which he makes, whether the donee is a resident or non-resident. If an individual dies domiciled in Canada the property passing on his death will be subject to estate taxes regardless of where the beneficiaries reside. A person may not necessarily be domiciled in a jurisdiction in which he is resident, although ordinarily he will be.

In view of the proposal to abolish the gift tax and estate tax and to tax Canadian residents on gifts received by them, it would be necessary to impose a tax on certain gifts made to non-residents. In the case of inter vivos gifts this tax should be imposed where the donor was resident in Canada. In the case of inheritances, the tax should be imposed if the deceased was domiciled in Canada at the time of his death. The reason for this distinction is that it is customary and most convenient to tax inter vivos gifts on the basis of the donor's residence, but it is recognized internationally that the taxation of inheritances should be based on the domicile of the deceased or the situs of the property. The taxation of gifts to non-residents which arise on death on the basis of the domicile of the deceased would not violate either the letter or the spirit of International Tax Conventions to which Canada is a party 24/.

In our opinion this proposed tax should be a withholding tax and should operate in the same manner as the withholding tax on investment income paid by residents to non-residents. We recommend in Chapter 26 that the withholding tax on such income other than dividends should be at the rate of 30 per cent. In our opinion this would be an appropriate rate for the taxation of gifts made to non-residents. It has the advantage of administrative simplicity in that it would be a flat rate. We also suggest that in order to avoid the necessity of reporting small gifts and to simplify administration, there should be an exemption of, say, $1,000 for gifts made by a donor to non-residents in a year.

In order to preserve neutrality between the treatment of gifts received by residents and those received by non-residents, in our opinion it would be desirable to permit a non-resident who received a gift which had been subject to withholding tax to elect to file a return as a Canadian resident. If he made such an election he would be required to include in his income the full amount of the gift before deduction of withholding tax, as well as his other income. He would have to agree to make all documents and records which were relevant to the calculation of his income available to the Canadian tax authorities. He would be entitled to a credit for foreign tax paid on his income from foreign sources. He would also receive credit for the withholding tax on the gift and, if it exceeds the tax payable on his income, including the gift, as reported in the return, he would be entitled to a refund.

One question that is often raised in any discussion on the taxation of transfers of wealth is whether such taxes should be reduced or eliminated to prevent residents from moving to another jurisdiction in order to reduce the tax on their estates. We have rejected the argument that Canada should either lower some or all of its taxes to the level of its lowest tax "competitor", or that Canada should turn itself into a tax haven of some sort. Both types of action can in the long run be self-defeating, are inequitable, and certainly should not be introduced by Canada. Under our proposals there would be no point in a taxpayer taking such action if his concern were the transfer of property to his widow, because such transfers would not be subject to tax. However, it would still be possible to reduce or eliminate the tax impact on other donees. If the donor left the country and the donee remained resident, then the full Canadian tax would continue to apply. However, under the reverse situation only the 30 per cent withholding tax would apply, so that this arrangement could be attractive for some taxpayers. If both donor and donee became non-resident, then no Canadian tax would be payable.

To offset tax avoidance by a donee who temporarily became non-resident, it would be necessary to provide that any Canadian taxpayer who became non-resident, and then became resident again, would have to include in his income,

in the year he returned to Canada, the value of all gifts received during the period in which he was a non-resident. A tax credit would be given for any gift taxes or estate taxes paid to a foreign country on such receipts.

Credit For Foreign Taxes

Any gift received by a resident of Canada would be included in his tax base regardless of where the donor resided. However, if a gift were received from a person resident or domiciled outside Canada it may have been subject to gift tax or estate tax in another country. Similarly, if a gift arising on death consisted of property situated in another country it may have been subject to estate tax in that country. In order to avoid double taxation we recommend that a person who received a gift which was in any of these categories should be entitled to a foreign tax credit for the gift tax, estate tax, or any similar tax which had been imposed on the gift in the country in which the donor was resident or domiciled or in which the property was situated. Such a credit should not be allowed, however, where the gift arose on death and consisted of property situated in Canada, since in these circumstances the other country should give credit for the Canadian tax.

The credit should be available whether the foreign tax was paid by the donor, or his estate, or by the donee. The amount deductible from Canadian tax would be limited to the Canadian tax which is applicable to the gift.

Gifts of Property Situated
in Canada

Under Part II of the Estate Tax Act a tax is imposed at the rate of 15 per cent on property situated in Canada which passes on the death of a person domiciled outside Canada. Credit for this tax will ordinarily be allowed in the country in which the deceased was domiciled. This tax is payable regardless of where the beneficiaries are resident or domiciled.

Under our proposals, if a beneficiary were resident in Canada, he would include the gift in his tax base in the manner already described. Because it is normal for a country to impose a tax on property situated therein when the property passes on the death of a person domiciled elsewhere, we recommend that a tax similar to that provided for in Part II of the Estate Tax Act should be imposed at the rate of 15 per cent on property situated in Canada that passed on the death of a person domiciled outside Canada to beneficiaries who were not resident in Canada.

Tax Conventions

Canada has an Estate Tax Convention with the United States, which was entered into in 1961, and with the United Kingdom, Ireland, France and South Africa, which were entered into some years prior to the introduction of the Estate Tax Act and which refer to succession duties. However, these latter Conventions may be interpreted as being applicable to the Canadian estate tax which was subsequently imposed.

It does not appear to us that the proposals outlined in this chapter are contrary to the provisions of any of these Conventions. Most of the restrictions which they would impose would be applicable only if Canada levied tax solely because the deceased had a Canadian domicile, or because he left property having a Canadian situs. Apart from the proposed 15 per cent tax similar to that imposed by Part II of the Estate Tax Act, the taxes we propose would not come within these categories. In any event, if there were a conflict between the Canadian taxing statute and an international Convention, the provisions of the Convention would prevail. However, if our recommendations were implemented, it might prove to be necessary or desirable for Canada to take steps to renegotiate the Conventions in such a way as to take account of the new system of taxing gifts.

Taxpayer Compliance, Administration
and Enforcement

At the present time the administration and enforcement provisions of the Income Tax Act apply to the income tax and the gift tax. The Estate

Tax Act provides for the administration of the estate tax; many of the provisions are similar to those contained in the Income Tax Act, while others are different and pertain only to an estate tax. Because gifts and inheritances under our proposal would be taxed as part of the comprehensive tax base, it would be necessary to include in the administrative structure special provisions to take into account the characteristics of gifts.

Because gifts are included in the tax base, the general income tax administration and enforcement provisions would apply to gifts as well as to other income. All components of the tax base would be reported in the same annual return. The filing of annual returns and information returns, the procedure relating to assessments and appeals, collection procedures and enforcement would be the same for gifts as for other forms of accretion to wealth. For these purposes it would be immaterial whether the recipient was an individual, a trust, or a corporation. Except for the special provisions referred to below, we have concluded that the administrative provisions as recommended can apply equally to the taxation of gifts.

For several reasons it would be necessary to take into account the position of the donor or his estate if the gift arose on death 25/. First, the returns filed by the estate of the donor could be utilized to ensure that donees would report and pay tax on the amounts they receive. Second, it may be desirable to require that an initial tax be paid on behalf of the donee by the executor or administrator of the donor. This is discussed in Chapter 21.

Wills commonly provide that the executors are to pay all taxes and death duties on property under their control out of the estate. It would be necessary to ensure that the provisions in our proposed tax structure relating to withholding by financial agents and intermediaries take such provisions into account.

While most of the general administrative provisions would be applicable to the taxation of gifts, we recommend that additional provisions should be added to deal with the following matters:

Reporting. It would be necessary to provide that donors or their personal representatives must report any gifts made to any individual other than a member of the donor's family unit which were over $100 in any taxation year.

Payment and Liability for Tax. In the case of a gift arising on death or through an inter vivos trust, it should be provided that the trustee could not make a distribution unless he had paid the initial tax, or had retained sufficient funds to pay the initial tax, or had obtained the consent of the tax authorities to the distribution.

It should also be provided that a donor who made a gift to a non-resident should withhold and remit the withholding tax payable with respect to the gift.

Ministerial Consents. In order to strengthen enforcement, it would be useful to have provisions such as sections 47 and 48 of the Estate Tax Act. These prohibit transfers of property, by anyone other than an executor, and the opening by any person, without the Minister's consent, of safes, vaults and other depositories which contain property of a deceased.

Liens on Property. There is no general lien on property for taxes owing under the Income Tax Act similar to that provided for in section 43 of the Estate Tax Act. That section provides in effect that any tax, interest or penalties payable under the Act by a successor to any real estate passing on the death of the deceased shall be a lien upon the real estate in favour of Her Majesty. The purpose of this lien is to prevent successors from selling the property and either leaving the country or spending the proceeds, leaving the Crown no way of collecting the tax. The present section 43 puts the onus on the purchasers of property to see that there is no lien for taxes.

We have considered whether the need for a lien would be reduced under our proposals where the gift would be included in the donee's tax base in the same way as other income. We recommend that it should be removed. We

think that the inconvenience it causes in real estate transactions generally is greater than its value in the collection of taxes. If, in practice, evasion of tax through lack of security should prove to be a serious problem, the government could consider returning to a system under which it would have agreements with the provinces to the effect that the provincial land transfer officials would require a waiver of the Minister in any case where property was transferred following the death of the owner. However, we would prefer to avoid this unless it was found necessary.

CONCLUSIONS AND RECOMMENDATIONS

1. All gifts, that is, all receipts of wealth, whether _inter vivos_ gifts or inheritances, should be included in the comprehensive tax base of the recipient. Transfers for inadequate consideration should also be regarded as gifts to the extent that the value of the property transferred exceeds the consideration.

2. The inclusion of all gifts in the comprehensive tax base should replace the present estate and gift taxes, and the legislation levying these taxes should be repealed.

3. Transfers between members of a family unit, for example to a spouse or dependent child, should not be taxable gifts.

4. The amount to be included in the tax base should be the net amount received, that is, the gross amount less legitimate expenses such as the expenses of administering an estate. If the gift were received subject to a condition, the cost of complying with the condition would be deducted.

5. Any gift which was renounced by the donee should not be included in his tax base but should be included in the base of the ultimate recipient, unless it reverted to the donor.

6. Where an individual has been given a power of appointment or a power of encroachment which would give him the uncontrolled right to apply property for his own use, he should be regarded as having received

the property unless he renounced it within 90 days after he became aware of it, or after it became exercisable, whichever was later.

7. A gift to a corporation should be included in its tax base unless made by the sole beneficial shareholder or by all the shareholders pro rata in accordance with their shareholdings.

8. Gifts to be held in trust would, generally speaking, be subject to an initial tax in the hands of the trust and the beneficiaries would receive credit for this tax on distribution. This is dealt with in Chapter 21.

9. In the case of a gift of an annuity, the present value of the annuity should be included in the income of the donee unless the donee qualified the annuity as a Registered Retirement Income Plan.

10. The following exemptions should be allowed:

    a) An annual exemption of $250 for each individual who filed a separate return, $250 for each spouse in a family unit, and $100 for each dependant who was a member of a family unit; the exemptions of the members of a family unit would be aggregated.

    b) A once-in-a-lifetime cumulative exemption of $5,000 for each individual on or after leaving his original family unit, applicable to gifts in excess of the annual exemption.

11. Gifts to tax-exempt bodies should, as under the present legislation, be free of tax.

12. Where a taxable gift had been received by a donor within four years before his death, a percentage of the gift should be exempt when passed on to his beneficiaries on his death. This percentage should range from 20 per cent to 80 per cent depending on how long before the donor's death the gift had been received.

13. Gifts arising on death should be included in income at the earlier of the date of actual or constructive receipt, or twenty-four months after the date of death. If the donee has not been identified within twenty-four months after the date of death, the gift would be included in the income of the trust that arose on death. If the gift were to be held in trust it would be included in the income of the trust at the time of obtaining probate, but in any event not later than twenty-four months after the date of death.

14. Fair market value, as developed by the courts, should be the test of the value of gifts and inheritances without additional statutory rules. Gifts arising on death should be valued at the date of death, but the donee, or trust, should have the right to revalue any of the property received by way of such a gift within two years from the date it had been included in income, or possibly longer under the general provisions for revaluation, and claim any loss resulting from the revaluation.

15. The rate schedule applicable to gifts should be the same as for other components of the comprehensive tax base. The same provisions with respect to averaging and with respect to deposits in Income Adjustment Accounts or investments in Registered Retirement Income Plans would apply to gifts as to any other income.

16. Where gifts consist of property other than money or marketable securities, the donee should have the right to pay the tax thereon in instalments over a five-year period, or in some cases ten years, with interest.

17. Gifts to non-residents should be subject to a 30 per cent withholding tax, subject to an annual exemption of $1,000 for each donor. A non-resident donee should have the option of filing a return as a Canadian resident. This tax would apply in the case of *inter vivos* gifts where the donor was resident in Canada, and in the case of inheritances where the deceased was domiciled in Canada.

18. Gifts received from non-residents should be included in income, but the donee would be entitled to a credit for foreign gift taxes or estate taxes paid.

19. A credit should also be allowed for estate tax imposed on property by the country in which the property was situated at the date of the donor's death.

20. Where property situated in Canada passed to a non-resident on the death of a person domiciled outside Canada, it should be subject to a 15 per cent tax of the type now imposed by the Estate Tax Act.

21. A number of special administrative provisions would be necessary to deal with gifts. However, the provision in the Estate Tax Act for a lien on real property should be removed.

REFERENCES

1/ C.S. Shoup, Federal Estate and Gift Taxes, Washington: The Brookings Institution, 1966.

2/ Section 111(2).

3/ Section 137(2).

4/ Section 26.

5/ However, the Income Tax Act provides in section 11(1)(v) that in the case of certain pension and annuity benefits, estate taxes and succession duties which are applicable to the payments are deductible in computing the recipient's income.

6/ Figures supplied to the Commission by the Department of National Revenue show that of over 14,000 gift tax returns filed in 1964, only 2,563 reported gifts which were subject to some gift tax and they reported taxable gifts of $38 million on which tax was paid of just over $6 million. Non-taxable gifts reported were approximately $125 million, and gifts unreported, because they were less than the exemptions, would also have been substantial.

7/ Representatives of the following groups made reference to this point: Canadian Manufacturer's Association; Canadian Chamber of Commerce; Estate Planning Association of Canada; Trust Companies Association of Canada.

8/ Alternative methods of taxing gifts are given in Appendix D to this Volume.

9/ See Chapter 18 for a description of the problems of deemed receipt of income on cancellation of debt, particularly in personal bankruptcies, as an exception to the general rule that there will be no deemed income from non-business debts. See Estate Tax Act, section 3(3)(a), (b) and

(e) which include in the taxable estate in some circumstances an artificial creation of a debt, the extinction of a debt, and debts rendered unenforceable by a limitation statute.

10/ Section 137(2).

11/ Section 4(1) and (2).

12/ Section 58(1)(o).

13/ Items now taxed under this section are principally the current expenses or taxes paid by the estate on property occupied by a beneficiary.

14/ This provision would be similar to section 137(2) of the Income Tax Act.

15/ Section 3(1)(d) of the Estate Tax Act is a general section bringing into tax gifts whenever made, of which actual and bona fide possession and enjoyment was not, at least 3 years prior to the death of the deceased, assumed by the donee and retained to the entire exclusion of the deceased.

16/ The various types of reserved powers and interests are set out in E.J. Mockler, J.G. Smith, and C. Frenette, Taxation of the Family, a study published by the Commission.

17/ The formulae which could be applied for this purpose are set out in Appendix E to this Volume.

18/ M.N.R. v. Estate of Edward William Bickle 66 DTC 5179.

19/ At common law a gift of an annuity is an income gift and the total payment is income, whether paid out of capital or not. Under the present Income Tax Act and practice, the part paid from capital is not taxable; section 11(1)(k) and Part III of the Income Tax Regulations.

20/ Under the present Estate Tax Act when non-commutable annuities are required to be valued they must be valued according to an annuity table prescribed in the Act, which assumes a rate of interest of 4 per cent.

This may result in the present value of the annuity for tax purposes being different from the cost of the annuity. If the annuity is commutable, the practice is to value the annuity at the rate of interest given in the annuity contract.

21/ Credits based on frequency of transfer may frequently be allowed under transfer tax systems which are not integrated with an income tax system. In some of these systems there is an assumption that the transfer tax should operate "once-in-a-lifetime".

22/ P. Nichols, Eminent Domain, 2nd ed., Albany, N.Y.: Mathew Bender and Co., 1917 p. 658, quoted in the Exchequer Court in many valuation cases.

23/ See Chapter 11 for the proposed rate schedule and a discussion of the principles involved.

24/ If it were found that this led to tax avoidance practices, consideration could be given to imposing a withholding tax on a gift passing to a non-resident on the death of a person who was resident in Canada but not domiciled in Canada, but the international implications would have to be carefully considered.

25/ It is to be noted that if the property given away has appreciated in value, tax will be levied on the donor in respect of his gains on the disposition of the property; such a tax may have to be calculated before the value of the gift can be computed, particularly where the gift arises on death.

CHAPTER 18

TRANSFER PAYMENTS AND MISCELLANEOUS RECEIPTS

In previous chapters the major components of income have been discussed. In this chapter we propose to deal with some additional types of receipts, most of which are not at present included in income for tax purposes but all of which fall within the proposed comprehensive tax base. These are: government transfer payments (unemployment insurance, workmen's compensation, family allowances and old age pensions), gambling gains and cancellation of debt. In addition we will discuss some other sundry kinds of income presently dealt with in sections 10 and 62 of the Income Tax Act. By restricting the discussion to these items we do not wish to imply that these are the only "other" receipts and gains that should be included in the comprehensive tax base. We make no claims to completeness. We hope it is well understood that under our approach all receipts and gains should be brought into income unless explicitly excluded, and that the absence of any discussion here does not mean that we would accept their exclusion from the tax base.

GOVERNMENT TRANSFER PAYMENTS

One function of government is to divert some of the flows of goods and services to the satisfaction of the collective wants of citizens. Another function is to alter the flows of goods and services within the private sector of the economy so as to achieve a more equitable distribution of purchasing power than might otherwise prevail. This redistribution function has two aspects, the tax side and the transfer side; here we are primarily concerned with the tax aspects of the latter. We are concerned mainly with the individual taxpayer-beneficiary, although we take this opportunity to discuss briefly some aspects of the transfer schemes themselves.

Government transfer payments are defined to include cash payments by governments to individuals other than those made in exchange for goods or services 1/. Among the more obvious and important transfer payments are the following: family allowances, old age security benefits, unemployment

insurance benefits, workmen's compensation benefits and social assistance and relief of all kinds. We feel that the present treatment of these receipts is confusing and inconsistent.

Family allowances are financed out of general government revenues. They are not included in the recipients' incomes for tax purposes. Any person who is entitled to receive them in respect of a child (whether he accepts them or not) is required to reduce the personal exemption for the child from $550 to $300. 2/ As a consequence of this arrangement taxpayers with low marginal rates of tax receive more in family allowances than they lose through the reduction of the exemption. The converse is true for taxpayers with high marginal rates who would be better off if no family allowances were paid and the full exemption were allowed.

Old age security is a funded scheme financed by three earmarked federal taxes: a 4 per cent tax added to the personal income tax rate (with a $120 limit), a 3 per cent tax added to the sales tax rate, and a 3 per cent tax added to the regular corporate income tax rate 3/. The recipients of these pensions take them into their incomes and are taxed on them in full.

Unemployment insurance benefits are financed by a tax on covered employees and their employers. It is a funded scheme. The tax is related to the level of earnings of the employee, as are the benefits. The employer's contributions are deductible as a business expense, but the employee's contributions are not deductible from personal income. Neither the employer's contributions on behalf of the employee nor the benefits themselves are subject to personal income tax.

Workmen's compensation is dealt with by provincial plans financed by pay-roll taxes on employers. Contributions are deducted as an expense by the employers. Covered employees make no contribution, and are not required to take the employer's contributions into their income for tax

purposes. The proceeds are not taxable in the hands of the compensated worker.

It would be difficult to conceive of a greater variation in arrangements than this.

Having reluctantly accepted the present transfer programmes, including the methods under which they are financed (except for old age security) for the reasons advanced in Chapters 6 and 7, we have developed our proposal; it does not go so far as we should like but it does have the merit of consistency. It is consistent with respect to our whole concept of the tax base, with respect to the treatment of any one programme relative to the others, and with respect to the private insurance-pension programmes beside which the government programmes frequently operate.

However, we recommend that before our proposals are implemented the amounts of all government transfer payments should be reviewed to ensure that their inclusion in income does not result in hardships.

In accordance with our concept of ability to pay, we recommend that the recipient of a transfer payment should include the benefit in his income because it increases the taxable capacity of the individual or the family. On the other hand, specific contributions to transfer programmes should be deductible from the individual's tax base 4/.

If all government transfers are brought into the tax base, those payments not now taxed may have to be increased in order to compensate for the new tax liability; for we do not mean to imply by our recommendation that the present payments are too large and should be reduced through taxation. Our recommended rate structure and system of tax credits will mean that some tax units will pay less tax even if their bases are increased by the addition of government transfers. The converse will be true for other taxpayers. On balance, we believe that our recommendations in this Report would increase the degree of redistribution achieved by the overall tax-transfer system,

even if the transfers themselves were not increased. We have made no attempt to determine what adjustments in the payments might be required, because this would take us outside our terms of reference.

Family Allowances

The present approach, under which the personal exemptions for dependants are reduced when they qualify for family allowances, should be abandoned. The tax credits for dependants that we recommend elsewhere in the Report should not be reduced for the family unit in receipt of family allowance payments. To be consistent with our basic approach to taxable capacity, we recommend that all family allowances should be included in the tax base of the tax unit which included as a dependant the child on whose behalf the benefits were paid. The minimum income below which no tax would be paid by reason of tax credits would therefore be unaffected by the family allowance status of dependent children. Over this minimum, full progressive rates of tax would apply to family allowance receipts. This also means that no taxpayer could be made worse off because a dependant qualifies for the family allowance, as can occur at present.

Old Age Security

We have said that we have reluctantly accepted the present methods of financing transfer programmes. To this general proposition we wish to make one exception. There seems no legitimate reason to continue to earmark taxes to finance the old age security programme. To maintain the three separate levies seems to serve no useful purpose, and is a source of inconvenience and needless complexity. The rate structures of the three relevant taxes should be adjusted accordingly. There also appears to be little if any merit in a continuation of the funding of the plan. We suggest that henceforth old age security pensions should be financed out of general revenues like family allowances.

Old age security receipts are now included in the tax base of the individual. This is consistent with our approach and we recommend that this should be continued.

Unemployment Insurance

Unemployment insurance contributions are made by employees and employers. In Chapter 14 we recommend that the employer's contributions should continue to be deducted as a business expense and not added to the income of the employee, and that the employee's contributions should be deductible by the employee whether or not the 3 per cent optional expense deduction in respect of employment income is taken. Benefits should be fully taxable in the hands of the recipient.

We believe that this is a fair treatment of unemployment insurance. It brings into income only the net benefit as measured by the difference between what the employee put into the plan, either directly or indirectly, and what the employee takes out. Not to tax unemployment insurance benefits would bestow a tax advantage on the man who, despite the fact that he was unemployed for some time during the year, had a larger total income, including unemployment insurance benefits, than the man who worked full time for lower wages. Throughout this Report we have tried to minimize the significance of the source of a man's income; it is the change in economic power that counts. We can see no reason for departing from that principle here. Of course, if unemployment insurance benefits were brought into income the net benefit would be reduced, particularly for individuals with substantial other income in that year. It may be necessary to increase gross unemployment insurance benefits to maintain their after-tax value for taxpayers in the lower income groups.

Workmen's Compensation

These programmes have two facets: they protect employers against

costs resulting from successful damage claims by their employees; and they protect employees against losses resulting from injuries sustained at work, whether or not the employer would have been held responsible. All contributions are made by employers. The benefits include lump sums in cases of death or permanent disability, income maintenance payments, and medical-hospital treatment.

We are satisfied that the most logical tax treatment of workmen's compensation would be to continue to allow a business deduction for the employer contributions, but to tax employees on the receipt of all benefits at full personal rates. It might be argued that the contributions of employers should be added to the incomes of the employees, but we reject this because under our proposals they would be deductible by the employee in any event. Taxing income maintenance receipts at full personal rates in the hands of the employee would be equitable relative to those who are working, and would be consistent with the tax treament of benefits received under private income maintenance insurance plans. It would also be fair to tax lump sum benefits received in cases of death or permanent disability, particularly in view of the relieving provisions we recommend in Chapter 13, including the provision which would permit the recipient to spread a lump sum benefit of this kind over his lifetime by purchasing a registered government annuity. Most of these payments are made to compensate for lost income that would have been taxed had it been received. Not to tax these sums would give the worker who received them an advantage over individuals who are not protected against accidents. Here, too, the level of the benefits should presumably be reconsidered by the provinces if this recommendation is accepted.

GAMBLING GAINS AND LOSSES

Gambling gains, like any form of receipt, increase the individual's taxable capacity and therefore should be brought into income as part of the comprehensive tax base. At present such gains are not taxed in Canada

unless it is shown that the taxpayer's gambling amounts to a business, and where the question has been brought before the courts the matter for decision has been whether the gains arose from a business activity or from a hobby 5/. Because the comprehensive tax base would bring in all receipts which increased economic power, regardless of source, the question of whether gambling gains arose from a business would no longer be important.

The greatest problem in bringing gambling gains into income would be enforcement. Reporting of small winnings would be largely a matter of taxpayer honesty, but it might be possible to establish a system by which large winnings would have to be reported by the payers, in much the same way as banks report the cashing of bond coupons by depositors. For reasons of administrative convenience it might be useful to provide for a small annual exemption for net gambling gains.

The treatment of gambling losses poses a problem. To the extent that gambling is a form of entertainment for the individual, gambling losses are a consumption expenditure and should not be deducted any more than theatre tickets and the costs incurred in playing golf or skiing. To the extent that gambling is a form of business activity, losses should be deducted against gambling gains and other income. There is, of course, no objective way of determining the motivations of gamblers, any more than there is for any taxpayer. The solution we suggest is a rigid rule that would achieve simplicity and at least a degree of fairness. We believe that gambling losses should be treated in the same way as other losses that are deemed to be a personal consumption nature. Thus, they should be allowed only as a deduction from gambling gains, and should not be set off against other income as ordinary losses would be. The carry-over of such losses should be limited in the same manner as other losses of a personal nature, with a two-year carry-back and an indefinite carry-forward against gambling gains. Such losses would be available for carry-forward only if reported for the year in which they were incurred.

CANCELLATION OF DEBT

Cancellation of debt occurs when there is no longer any legal obligation binding upon a debtor to pay all or some part of his debts. Examples are court-approved or voluntary arrangements by which a liability is reduced or cancelled, or the involuntary cancellation that occurs by the operation of the Statute of Limitations under which the right to enforce collection is lost.

At present, cancellation of debt generally gives rise to income only when it is considered to be some kind of price rebate. Court cases in this area have dealt only with trade liabilities, non-trade debts being considered to be of a capital nature. In the leading case of British Mexican Petroleum Company, Ltd. v. C.I.R., 6/ the House of Lords held that cancellation of trade debts in a year subsequent to those in which they arose did not give rise to income. This decision was followed in Canada by the Exchequer Court in the case of Plimley Automobile Company Limited v. M.N.R. 7/. However, in the case of Oxford Motors Ltd. v. M.N.R. 8/ the Supreme Court of Canada held that rebates given the taxpayer by its supplier based on the number of cars sold from its stock were trade receipts and taxable, even though the rebates were to be applied against the taxpayer's indebtedness to the supplier.

In the United Kingdom the decision in the British Mexican Petroleum Company, Ltd. case was nullified in 1960 by section 36 of the Finance Act, 1960, which requires that where any debt has been allowed as a deduction for the purpose of computing income from a trade or profession and is subsequently released, the amount released must be regarded as a receipt of such trade or profession.

We believe that when a debt is cancelled the debtor has, in effect, received income. For, as the cancellation of liabilities increases a person's net assets, his economic power is increased by the amount of

the debt cancelled. Where a debtor who is in business has one or more of his debts cancelled, he has claimed expenses or has recorded assets which in fact will have cost him nothing. Income in prior years has, therefore, been understated, and it appears only reasonable to require an offsetting adjustment in the current year. Because such an adjustment will usually only arise when there is a loss, it will serve to reduce the loss rather than to create taxable income.

We are not recommending that the borrower should necessarily be considered to have received income at the time the lender merely writes off all or some portion of the debt. Although to regard income as arising to one party at the time the expense was recorded by the other party has the virtue of consistency, such treatment would not be practical in this case, and in fact may not be theoretically correct, because the borrower might still regard his obligation as a liability that he intended to meet.

Deeds of gift and of forgiveness would also, under our recommendations, result in income to the beneficiary and, because all income would receive similar treatment, it would be of little importance to the beneficiary whether such a transaction were considered as a gift or as forgiveness of debt. Loans between persons not dealing at arm's length should be deemed to be gifts unless satisfactory terms of repayment were agreed upon and generally complied with. This provision would be necessary because otherwise transactions which resembled loans could be set up as a mere cloak for a gift or bequest. Therefore, in such a case income should be deemed to arise when the debt is incurred rather than when the debt is later cancelled.

There is a problem in determining when cancellation should give rise to a deemed receipt of income. Cancellation of a debt usually requires some overt act on the part of the creditor. Debts may, however, become unenforceable by reason of the Statute of Limitations. We believe it reasonable to deem that income has arisen upon the expiry of the limitation period. Therefore income should arise at the earliest of: the time of

acknowledgment of the cancellation of the debt by the debtor; the time the court approved an arrangement under the Bankruptcy Act; or the expiry of the limitation period. It should be noted that, because a limitation period does not bar the right but only the remedy, it would not prevent collection unless specifically pleaded in an action to collect the debt. Furthermore, the limitation might cease to apply because of a subsequent acknowledgment of the debt or part payment by the debtor. Nevertheless, because the limitation period is fixed, we think it should be the latest time to which the recording of income should be deferred by the debtor. In any case, whenever a debtor pays an amount which he had previously included in income on the ground that his indebtedness to pay the amount was cancelled, he should be allowed a deduction from income. This should effectively prevent any hardship arising from the inclusion in income of the cancelled debt.

Under the broad concept of income advocated in this Report, cancellation of a debt would result in income whether the debtor was solvent or insolvent. However, by definition the insolvent debtor would not be in a position to pay tax. In the United States this problem has been handled by declaring that if a taxpayer is insolvent both before and after a debt is forgiven, no income is realized. If he is solvent after the debt is forgiven, income is realized to the extent that he was made solvent by the cancellation. There has been a great deal of litigation in connection with this point and the Internal Revenue Code now provides generally with respect to both corporations and individuals that the amount of trade debts cancelled will not be included in computing income if the taxpayer agrees to reduce the basis of his assets by the amount of income attributable to the discharge of the indebtedness. These provisions therefore allow a postponement of tax until the assets are realized.

The above approach may appear complex. However, for most businesses, bringing into income the cancellation of debt would generally only reduce the current year's loss, or the prior year's loss carry-forward, and would

not give rise to taxable income. This would not be so where either the taxpayer was in good financial condition, or where insolvency resulted from some circumstance that did not involve a business loss. In the first case there should be no problem in meeting the tax liability, while it is difficult to conceive of the latter situation arising, particularly if our recommendation is adopted that virtually all expenditures should be deductible. The problem of discharging the tax liability could be met by allowing up to five years to pay the tax, or by introducing a provision similar to the one adopted in the United States which allows the option of adjusting the tax basis of the underlying assets.

However, in the case of personal debts (whether or not there is a bankruptcy) the problem would not always be solved merely by the alteration of a loss carry-back or carry-forward, for the expenditure may have been an item of personal consumption and not a business expense used to reduce income. In these circumstances, to add a tax assessment to the travails of an individual already burdened with the consequences of financial failure seems to us to be excessively harsh treatment, and we therefore recommend that cancellation of debt should not result in income to the debtor if the debt arose in a transaction at arm's length and if the original expenditure was not deductible in computing income.

SUNDRY OTHER ITEMS OF INCOME

There are several kinds of receipts that are specifically excluded from income under section 10 or exempt from tax under section 62(1)(a) of the Income Tax Act or under other legislation.

The comprehensive tax base we recommend should encompass all forms of income, and therefore in principle all exclusions and exemptions should be terminated. We recommend that all income should be taxed in full and, if specific relief were required in respect of payments by the government, the need should be met through higher payments.

Certain items referred to in section 10 such as workmen's compensation and unemployment insurance have already been discussed. The balance of the items are briefly discussed below, along with our specific recommendations for changes. Because some of the items will expire in time or are subject to circumstances that preclude an alteration in the current tax treatment, we have not suggested that all of these receipts should become taxable.

Statutory Exemptions:
Section 10(1)(a)

Tax exemptions provided for in other legislation should be removed. In particular, the tax-free allowances for Members of Parliament should be withdrawn. Members of Parliament should be treated on the same basis as other employees and so should be required to bring their allowances into income, and at the same time should be allowed to deduct their expenses of earning employment income including election expenses. We would expect that it would be accepted that the regular place of business of a Member of Parliament is his riding, so that all expenses incurred while in Ottawa and in travelling to and from Ottawa would be deductible as long as they fell within the limits established for such expenses.

War Savings Certificates:
Section 10(1)(b)

The last of these certificates matured in 1954, and no income has accrued since. The section appears to be no longer necessary. Similar tax exemptions should not be made in future for debt instruments sold by government.

Ship or Aircraft of Non-Residents:
Section 10(1)(c)

This exemption should be removed if enforcement is practical.

Service Pension or Allowances:
Section 10(1)(d)

Exemption should be eliminated after consideration has been given to a revision of the amounts payable.

Service Pension from Another Country:
Section 10(1)(e)

There is a problem with respect to individuals now resident in Canada in receipt of service pensions from other countries. Unless our recommended tax credits offset the tax, the inclusion of these pensions in income could create hardships. Therefore, we would suggest a five- to ten-year time lag before these pensions were taxed, so that those individuals who have come to Canada on the understanding that their service pensions are not taxable would have an opportunity to adjust their affairs.

Halifax Disaster Pensions:
Section 10(1)(f)

These pensions will soon expire, if they have not already done so. If it is impossible to adjust the amounts, the present exemption should be maintained.

German Compensation:
Section 10(1)(fa)

These payments will expire in time and, because Canada cannot adjust the amount of compensation, this exemption should be continued.

Royal Canadian Mounted Police Pension:
Section 10(1)(ga)

Same as section 10(1)(d).

Profit Sharing Plans:
Section 10(1)(i)

To the extent that these plans are not registered retirement savings plans, as discussed in Chapter 16, payments into these plans by the employer should be subject to tax in the employee's hands at that time. This is the same treatment as we recommend for unregistered pension plans.

Prospecting:
Section 10(1)(j)

This exemption should be repealed as we recommend in Chapter 23.

Governor General:
Section 10(1)(k)

The exemption of the Governor General should be maintained and extended to Lieutenant-Governors.

Expense Allowance for Members of a Legislative Assembly:
Section 10(2)

Same as section 10(1)(a).

Municipal Officers' Expense Allowance:
Section 10(3)

Same as section 10(1)(a).

Employees of Another Country:
Section 62(1)(a)

Because of the special status of foreign diplomatic personnel this exemption must remain on a reciprocal basis. However, efforts should be made to ensure that the privilege is not abused and that foreign personnel who are essentially conducting commercial activities in Canada are subject to Canadian tax.

CONCLUSIONS AND RECOMMENDATIONS

TRANSFER PAYMENTS

1. The amounts of all government transfer payments should be reviewed in the light of our recommendations in order to ensure that their inclusion in income would not result in hardships.

2. All government transfer payments, including family allowances, old age security payments, unemployment insurance benefits and workmen's compensation payments, should be brought into the income of the recipient, with deductions allowed for specific non-tax contributions to transfer programmes.

3. Where a family is in receipt of family allowance payments, the tax credits for dependants should not be reduced.

MISCELLANEOUS RECEIPTS

4. Gambling gains should be brought into income, perhaps subject to a small annual exemption for administrative reasons. Gambling losses should not be allowed as a deduction from other income, but should be deductible from gambling gains, with a carry-back of two years and an indefinite carry-forward.

5. Cancellation or forgiveness of debt should be treated as income of the debtor, except in those instances when the debt arose in a transaction at arm's length and was not deductible in computing income. The debt should be deemed to be cancelled at the earliest of the following times: the time of acknowledgment of the cancellation of the debt by the debtor; the time the court approved an arrangement under the Bankruptcy Act; or the expiry of the limitation period.

6. Specific receipts now excluded from income by section 10 of the Income Tax Act should be included in income except in certain cases where the payments will terminate in the near future or where special circumstances warrant their continued exclusion from income.

REFERENCES

1/ This definition excludes, for example, interest charges on government bonds, superannuation payments to retired civil servants, payments under annuities purchased from the government and Canada Pension Plan benefits. See Chapter 16 for a discussion of pensions.

2/ Section 26(1)(c).

3/ Old Age Security Act, R.S.C. 1952, Chapter 200, section 10.

4/ In principle, when contributions are made by an employer on behalf of an employee the employer's contribution should be added to the employee's income and the employee should deduct both the employer's contribution and his own. However, the employee's position is simplified where there is no limitation on the deduction, by ignoring the employer's contribution.

5/ M.N.R. v. Morden, [1962] Ex. C.R. 29; M.N.R. v. Walker, [1952] Ex. C.R. 1.

6/ (1932) 16 T.C. 570.

7/ [1958] Ex. C.R. 270.

8/ [1959] S.C.R. 548.

APPENDIX A

PROBLEMS OF TAX AVOIDANCE

THE MEANING OF "TAX AVOIDANCE" AND "TAX EVASION"

Before proceeding to examine the problem of tax avoidance, it would be well to explain what we mean by that expression, and how it differs from "evasion". The terms "avoidance" and "evasion" are not defined in the Income Tax Act, and, indeed, are rarely used in that statute.

The terms "avoid" or "avoidance" appear in section 51(2) which gives the Minister certain powers where "a taxpayer is attempting to avoid payment of taxes"; in section 137(2), which provides for the imposition of tax in circumstances where certain indirect payments or transfers are made, "whether or not there was an intention to avoid or evade taxes under this Act"; in section 138(1), which confers on the Treasury Board certain powers where one of the main purposes for a transaction was "improper avoidance or reduction of taxes that might otherwise have become payable under this Act"; and in section 138A(1), which empowers the Minister to make a direction where certain transactions are carried out, one of the purposes of which, in the opinion of the Minister, is to effect a reduction or disappearance of assets of a corporation in such a manner that any tax that might otherwise have become payable under the Act on a distribution of income "has been or will be avoided".

The term "evade" appears in section 56(1), which provides for the imposition of a penalty on every person "who has wilfully, in any manner, evaded or attempted to evade payment of the tax payable by him under this Part"; in section 132, which creates offences if certain steps are taken or attempts made to evade payment of tax; and in section 137(2). (See supra.)

Writers on the subject of taxation are usually careful to draw a distinction between tax evasion and tax avoidance. The distinction drawn between these concepts by the United Kingdom Royal Commission on the Taxation of Profits and Income would seem to be equally appropriate for Canadian tax

purposes. The term "evasion", said the Royal Commission:

> "...denotes all those activities which are responsible for a person not paying the tax that the existing law charges upon his income. Ex hypothesi he is in the wrong, though his wrongdoing may range from the making of a deliberately fraudulent return to a mere failure to make his return or to pay his tax at the proper time." 1/

The Royal Commission defined tax avoidance in the following way:

> "By tax avoidance, on the other hand, is understood some act by which a person so arranges his affairs that he is liable to pay less tax than he would have paid but for the arrangement. Thus the situation which he brings about is one in which he is legally in the right, except so far as some special rule may be introduced that puts him in the wrong." 2/

Thus, evasion is illegal; avoidance is not.

For our purposes, as will be elaborated below, the expression "tax avoidance" will be used to describe every attempt by legal means to prevent or reduce tax liability which would otherwise be incurred, by taking advantage of some provision or lack of provision in the law. It excludes fraud, concealment and other illegal measures. Also, it presupposes the existence of alternatives, one of which would result in less tax than the other. Moreover, motive would seem to be an essential element of tax avoidance. A person who adopts one of several possible courses because that one will save him the most tax must be distinguished from the taxpayer who adopts the same course for business or personal reasons. However, a man's purpose or intention may be difficult to determine. "The devil himself knoweth not the mind of man". Unless a taxpayer makes an admission as to his purpose or has clearly indicated his motivation in some other way, his purpose or intention can be determined only by inference or assumption. If he cannot give a reasonable explanation for carrying out a particular transaction or for carrying it out in a particular way, it may be assumed from the circumstances and the nature of the transaction that his purpose was to avoid tax liability.

METHODS OF TAX AVOIDANCE

Tax avoidance may take many forms.

1. The taxpayer may wilfully avoid having income. The high tax rates are often maligned for reducing the incentive on the part of taxpayers to make investment or engage in productive activity. Some taxpayers may prefer to conserve their resources, avoid risk, and enjoy their leisure rather than share with the state a substantial portion of the fruits of their labours. For this kind of tax avoidance there can be no remedy but to lower the rates of taxation and so remove the undesirable influence on incentive.

2. Certain types of tax avoidance are openly countenanced by the law, and, of course, it is perfectly legitimate to take advantage of these types. For example, the interest from certain government bonds was tax free under section 4(j) of the Income War Tax Act, and the Income Tax Act gives taxpayers a number of options or elections as to how certain types of income are to be taxed. For example, section 85A gives the taxpayer an election as to how stock option benefits are to be taxed; section 105 permits the distribution of corporate surplus in some circumstances at a flat 15 per cent rate. A taxpayer may make a gift to charity or get married in the last month of the year with the purpose of increasing his deductions and reducing his tax liability. In these cases both the language of the statute and the policy of the statute combine to permit these courses of action. The controversy with respect to such avoidance is one of policy rather than of law.

3. In other cases the taxpayer may have availed himself of various schemes and devices in order to get relief from what might be considered his just burden of taxation by arranging his transactions so as to fall outside the four corners of the taxing statute. A few random examples are given below:

a) Income splitting by means of intra-family arrangements, trusts

and controlled corporations, so as to escape progressive tax rates.

b) Distribution of corporate surplus at less than the normal rates of personal or corporate tax, that is, "dividend stripping".

c) Dissociating associated companies so as to escape the higher corporate tax rate under section 39.

d) Depersonalizing a personal corporation by having it acquire an active business, in order that dividend income will be received tax free.

e) Purchasing a defunct company which has incurred a heavy loss so as to use up that loss against future profits.

f) Arranging for what would normally be income to be received as capital, for example, by taking a discount or a premium on a loan instead of charging a higher rate of interest to compensate for the capital risk.

g) Transferring income to a corporation or trust established in a jurisdiction which imposes no income tax or imposes such tax at low rates.

WHETHER TAX AVOIDANCE IS AN EVIL

It is to be observed that the use of such arrangements is far from being universally criticized or condemned. The United Kingdom Royal Commission on the Taxation of Profits and Income pointed out that there was no general principle that a man owed a duty not to alter the disposition of his affairs so as to reduce his existing liability to tax and ventured the opinion that such a general principle neither could nor ought to be introduced. The following reasons were given by the Commission:

"First, it is too wide to be maintainable. Suppose that a man, influenced by the high rate of taxation on his marginal income,

> distributes some of his investments among adult members of his family to whom he had been in the habit of paying allowances out of his taxed income. Suppose that another man, similarly influenced, sells some of his income-yielding investments in order to put the proceeds into National Savings Certificates. Is either a case in which the man ought to be treated for tax purposes as if his income was still what it was before the transaction? Secondly, there is no true equity to support such a general principle. Taken at any one moment of time the affairs of different taxpayers are arranged in the most various forms and the extent to which they respectively incur a burden of tax may vary correspondingly. There is no reason to assume that the situation of any one taxpayer at that moment is the fairest possible as between himself and others differently situated: and if there is not, it seems wrong to propound any principle that would have the effect of fixing each taxpayer in his situation, without allowing him any chance of so altering his arrangement as to reduce his liability to assessment." 3/

However, after affirming the general right of a taxpayer to arrange his affairs so as to pay the least amount of tax, the Royal Commission did go on to criticize those arrangements by which a taxpayer deflected his income to others while retaining effective control of the enjoyment and disposition of it, as where he used a corporation or trust:

> "The tax avoidance that should be struck at is to be found in those situations in which a man, without being in law the owner of income, yet has in substance the power to enjoy it or control the disposition of it in his own interest. For it is in such situations that a man can be seen to be the effective owner of income, though he would not be liable, if legal forms alone were attended to, to pay his share of tax in respect of it." 4/

Others contend that a taxpayer is entitled to be astute to prevent the depletion of his resources by the government. Tax laws, they say, are an encroachment on the liberty of the citizen, who is perfectly entitled to get around them if he can legally do so. There is no obligation to contribute to the support of government when the statute does not require the taxpayer to do so. The legislation spells out the liability for taxation, which depends on objective facts regardless of the purpose or intent of the individual.

On the other hand, a variety of considerations may be catalogued in condemnation of tax avoidance of the kind referred to in paragraph 3 above:

1. Loss of revenue to the government; the amount is difficult to estimate.

2. The fruitless expenditure of intellectual effort by some of the country's ablest lawyers, accountants and administrators in the economically unproductive tax avoidance battle.

3. The sense of injustice and inequality which tax avoidance raises in the breasts of those unable or unwilling to profit by it. Opportunities of tax avoidance are not equal, for it clearly has little practical meaning to salaried and wage-earning taxpayers from whom tax is deducted at source.

4. Deterioration of tax morality. When a taxpayer employs a variety of schemes and devices to exploit the loopholes in the Income Tax Act and thereby minimize his taxes, he lowers the level of tax morality. Indeed, it may be said that the widespread practice of tax avoidance will lead to an increase in tax evasion. Taxpayers who have little opportunity to practise tax avoidance and see others using legal means to reduce their taxes are sorely tempted to adopt illegal methods to achieve the same result. As has happened in other countries, if taxpayers generally form the notion that tax avoidance is an accepted practice, the system of self-assessment may break down.

5. A taxpayer who uses devices and schemes to minimize the tax that he should pay reduces his tax burden unfairly and shifts the avoided tax to other taxpayers. There is little information available as to how much of the tax burden is shifted through tax avoidance devices.

In general we concur with the conclusions of the United Kingdom Royal Commission on this subject. If a man gives up the right to income and to any control over the income or the source of income, even with the avowed purpose of reducing his tax liability, he should not be taxed on that income. However, if he contrives matters in such a way that he continues to enjoy the benefits of income, or if he continues to control the source or disposition of income, he should not be allowed to reduce his liability

below what a taxpayer in similar circumstances receiving the income would normally expect to pay under the tax system. The taxing statute should contain sufficient provisions to prevent this latter type of avoidance.

THE ATTITUDE OF THE COURTS TOWARD TAX AVOIDANCE

Canada and the United Kingdom

As a prelude to examining the legislative approach to tax avoidance, it is important to examine the attitude of the courts to the subject. The need, if any, for a legislative remedy or solution and also the form it should take must depend in part on the judicial approach to tax avoidance and to the interpretation of taxing statutes.

The traditional judicial approach to the determination of tax liability is, first, to determine the meaning of the statute in accordance with certain well-established canons of construction and, second, to determine the true legal effect of the taxpayer's transactions and arrangements, and then decide whether they fall within the statutory language.

As for the first step, it is a well-established rule of English and Canadian income tax law that taxing statutes are to be strictly construed and effect given only to the letter of the law, according to the plain, ordinary meaning of the language used, regardless of its spirit or the supposed intention of Parliament. Perhaps the most frequently quoted authority for this proposition is the following passage from the judgment of Lord Cairns in Partington v. Attorney-General:

> "If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible, in any statute, what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute." 5/

This passage has been cited with approval in subsequent decisions of the House of Lords and also by the Supreme Court of Canada 6/.

According to one commentator, "The origin of this rule of strict construction of taxing statutes is not very clear. It probably originated in the dislike of judges for unmeritorious defences to civil actions based on stamp duty points and was originally stated more as a rule that the onus was on the Crown to show clearly that the case fell within the statute." 7/

The application of the rule of strict construction has been carried to extreme lengths by Canadian courts in cases arising under section 21 of the Canadian Income Tax Act. For example, in M.N.R. v. MacInnes 8/ the taxpayer gave money and bonds to his wife, who purchased bonds with the money; she then sold all of the bonds and with the proceeds purchased other property which she sold; with the proceeds of that sale she purchased still other income-yielding property. The income from the last purchased property was sought to be taxed as income of the husband. It was held that the section taxed the transferor only on the income from the property transferred by him to his wife or from property substituted therefor, and did not extend to property substituted for such substituted property. A taxable substitution was limited to one exchange. As has so often been the case when decisions have been based on a narrow, literal construction of the statutory language in disregard of legislative policy, Parliament responded immediately with an appropriate amendment 9/.

The courts frequently refer to the rule of strict construction and often rely on it to reach a decision, either in favour of the taxpayer or against him, which is not consistent with the general scheme of the legislation or its apparent intent. On the other hand, the courts sometimes ignore the rule or modify it in order to reach what seems to be a sensible result. For example, in Settled Estates Limited v. M.N.R. 10/ the Supreme Court held that a trust was not an "individual" for the purpose of determining whether a corporation was a personal corporation notwithstanding

the words of section 63(2), which provides that "a trust or estate shall, for the purposes of this Act,...be deemed to be...an individual". In M.N.R. v. Pillsbury Holdings Limited 11/ the Exchequer Court restricted the meaning of the general words "a benefit or advantage has been conferred on a shareholder by a corporation", which appear in section 8(1), to refer only to benefits or advantages conferred on a shareholder qua shareholder. In other cases the wording of a statutory provision is ambiguous and the court must resolve the ambiguity. This is normally done by reference to the context and in such a way as to give a reasonable meaning to the provision 12/.

As for the second step, there is an abundance of judicial authority to the effect that the legal significance of a taxpayer's conduct and arrangements is to be determined without reference to his motives in seeking to avoid tax. The proposition is often put that a court will give effect to the substance rather than to the form of the taxpayer's transactions, meaning that the court will give effect to the true legal relationship arising from the transaction, and will collapse mere sham transactions. The leading statement of this rule was uttered by Lord Tomlin in I.R.C. v. Duke of Westminster:

> "Apart, however, from the question of contract with which I have dealt, it is said that in revenue cases there is a doctrine that the Court may ignore the legal position and regard what is called 'the substance of the matter,' and that here the substance of the matter is that the annuitant was serving the Duke for something equal to his former salary or wages, and that therefore, while he is so serving, the annuity must be treated as salary or wages. This supposed doctrine (upon which the Commissioners apparently acted) seems to rest for its support upon a misunderstanding of language used in some earlier cases. The sooner this misunderstanding is dispelled, and the supposed doctrine given its quietus, the better it will be for all concerned, for the doctrine seems to involve substituting 'the incertain and crooked cord of discretion' for 'the golden and streight metwand of the law'. [4 Inst. 41]. Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine of 'the substance' seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable." 13/

As a general rule the reasoning in the Duke of Westminster case is regarded with favour by the courts in Canada, and taxability is normally determined according to the strict legal position of the taxpayer and the legal effect of the transaction. That is to say, the courts normally take the words of the taxing statute as they find them and apply them to any particular transaction on the basis of its legal effect also as they find it. This is the rule of the legal result or effect as opposed to that of financial or economic effect 14/.

The court will not, of course, recognize or give effect to sham transactions. Lord Tomlin in the Duke of Westminster case warned that his statement quoted above must not be taken to mean that the apparent legal form of a transaction governs even if it is not intended to have legal effect. He stated:

> "There may, of course, be cases where documents are not bona fide nor intended to be acted upon, but are only used as a cloak to conceal a different transaction. No such case is made or even suggested here. The deeds of covenant are admittedly bona fide and have been given their proper legal operation. They cannot be ignored or treated as operating in some different way because as a result less duty is payable than would have been the case if some other arrangement (called for the purpose of the appellants' argument 'the substance') had been made." 15/

This rule has also been applied in Canada. For example, in Front & Simcoe Limited v. M.N.R. 16/ the Exchequer Court refused to recognize the form in which a transaction was cast by finding that it was only a mask to hide another transaction—the money in question was asserted to be damages for cancellation of a lease, but the Court found that it was in fact prepaid rent under the lease 17/.

In time of grave national crisis, the House of Lords was critical of the doctrine set down in the Duke of Westminster case and heaped moral censure on the practitioners of tax avoidance. Lord Simon said in Latilla v. I.R.C.:

> "My Lords, of recent years much ingenuity has been expended in certain quarters in attempting to devise methods of disposition

> of income by which those who were prepared to adopt them might enjoy the benefits of residence in this country while receiving the equivalent of such income without sharing in the appropriate burden of British taxation. Judicial dicta may be cited which point out that, however elaborate and artificial such methods may be, those who adopt them are 'entitled' to do so. There is, of course, no doubt that they are within their legal rights, but that is no reason why their efforts, or those of the professional gentlemen who assist them in the matter, should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship. On the contrary, one result of such methods, if they succeed, is, of course, to increase pro tanto the load of tax on the shoulders of the great body of good citizens who do not desire, or do not know how, to adopt these manoeuvres." 18/

After the war, however, the Duke of Westminster principle seemed less obnoxious to the House of Lords. Thus, in Vestey's Executors v. I.R.C., Lord Normand said:

> "Parliament in its attempts to keep pace with the ingenuity devoted to tax avoidance may fall short of its purpose. That is a misfortune for the taxpayers who do not try to avoid their share of the burden, and it is disappointing to the Inland Revenue. But the court will not stretch the terms of taxing Acts in order to improve on the efforts of Parliament and to stop gaps which are left open by the statutes. Tax avoidance is an evil, but it would be the beginning of much greater evils if the courts were to overstretch the language of the statute in order to subject to taxation people of whom they disapproved." 19/

In 1955, when the Royal Commission on the Taxation of Profits and Income submitted its report, they stated that "the prevailing doctrine in this country" is that established in the Duke of Westminster case.

The effect of the two facets of the judicial approach to taxation described above is to favour the careful or foresighted taxpayer who, by arranging his affairs, may bring his gains outside the sphere of taxation provided for in the statutory language which he hopes and expects will be strictly and literally construed by the courts. However, it also works against the unwary taxpayer who fails to arrange his affairs and runs afoul of a technical provision in the Act. He may incur a tax liability which was never intended, but he is trapped by the legal effect of his transaction and the literal interpretation of the statute.

The argument in favour of the traditional judicial approach is that it

provides a degree of certainty. It enables the taxpayer to plan his affairs and make business decisions with some assurance of what the tax consequences will be. If the courts were to depart from either of the principles we have referred to without very good reason, they would be embarking on a dangerous path. Their decisions would depend on the personal views of the judge as to what the law should be, or what it was intended to be, rather than on what the legislature has said that it is.

We agree that the courts should not depart lightly from the words used in the statute or from the legal effect of a transaction in resolving its tax implications. However, it may be suggested that the courts should also have regard to the equities of the situation and the apparent purpose of Parliament, and should modify or limit the strict literal meaning of words where this is necessary to reach a sensible result. This would assist in the development of a better and more equitable tax structure. It would reduce the necessity for so many loophole-closing amendments which gradually clutter up and complicate the statute. The courts, however, must reach their decisions primarily by reference to the statute. Their job will be made much easier if the legislation is well drafted and consistent in itself.

The United States

The Construction of Taxing Statutes. It is illuminating to trace the evolution of the judicial approach to the interpretation of taxing statutes and to tax avoidance under United States income tax laws. The traditional English and Canadian rules of statutory interpretation were at one time embraced by United States judges. Thus, in United States v. Merriam 20/ the Supreme Court applied the oft-quoted passage from Lord Cairns' judgment in Partington v. Attorney-General, and in Gould v. Gould the court said:

> "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favour of the citizen." 21/

This approach to statutory interpretation has since been discarded. The more recent approach is shown by the opinion of Stone, J. in White v. United States:

> "We are not impressed by the argument that, as the question here decided is doubtful, all doubts should be resolved in favor of the taxpayer. It is the function and duty of courts to resolve doubts. We know of no reason why that function should be abdicated in a tax case more than in any other where the rights of suitors turn on the construction of a statute and it is our duty to decide what that construction fairly should be." 22/

Judicial Anti-Avoidance Doctrines. A similar evolution has occurred with respect to the rule that every man is entitled to arrange his affairs so as to minimize his taxes. In the leading case of United States v. Isham 23/ the Supreme Court held, in a prosecution for failure to affix a stamp to an instrument, that the form of the instrument rather than its substance and effect governed and that the stamp was not required. The Court said:

> "To illustrate. The Stamp Act of 1862 imposed a duty of two cents upon a bank check, when drawn for an amount not less than twenty dollars. A careful individual, having the amount of twenty dollars to pay, pays the same by handing to his creditor two checks of ten dollars each. He thus draws checks in payment of his debt to the amount of twenty dollars, and yet pays no stamp duty. This practice and this system he pursues habitually and persistently. While his operations deprive the Government of the duties it might reasonably expect to receive, it is not perceived that the practice is open to the charge of fraud. He resorts to devices to avoid the payment of duties, but they are not illegal. He has the legal right to split up his evidences of payment, and thus to avoid the tax. The device we are considering is of the same nature." 24/

This doctrine was discarded to a large extent in the decision of Gregory v. Helvering 25/. In that case the court was required to construe the meaning of the tax-free reorganization provisions of the Revenue Act of 1928. Mrs. Gregory, in a technically perfect scheme, carried out a series of transactions each of which was tax free under a literal interpretation of the statute. The effect of all the transactions was to permit her to make a gain on the sale of stock which normally would have been taxable. But the Court refused to interpret the statute literally. It brushed aside the "elaborate and devious" form of the transaction masquerading as a

reorganization and upheld the government's position. In doing so it explicitly excluded from consideration the question of motive—avowedly avoidance—and rested its conclusion on the ground that the statute meant by reorganization a transaction in furtherance of the reorganized corporation's business. It held that when measured by this test the scheme was outside the plain intent of the statute. Thus, the court interpolated into the Congressional definition something not written there, namely, the requirement of business purpose.

The "business purpose" doctrine is not limited to the reorganization provisions of the Code, but is applied to the entire statute. In Weller v. Commissioner the court said: "Thus the principle laid down in the Gregory case is not limited to corporate reorganizations, but rather applies to the federal taxing statutes generally. The words of these statutes which describe commercial transactions are to be understood to refer to transactions entered upon for commercial purposes and 'not to include transactions entered upon for no other motive but to escape taxation'" 26/. The Internal Revenue Service has used the doctrine as an overall weapon for combating tax avoidance and has succeeded in some instances and failed in others. The precise scope of the doctrine is not entirely clear. In the words of one commentator:

> "Where do we draw the line in defining the areas to which the business purpose doctrine applies? This is not an easy question to answer, and it is complicated by the fact that among the judges of the many courts over our country before whom tax cases are tried or heard on appeal, there are wide divergencies in attitudes towards the doctrine, ranging from empathy to outright hostility.... I would venture the following as a capsulized statement of the contours of the test. The business purpose doctrine is an appropriate tool for testing the tax effectiveness of a transaction, where the language, nature and purposes of the provision of the tax law under construction indicate a function, pattern and design characteristic solely of business transactions. While the courts have not articulated the doctrine in precisely these terms, most of the cases decided by courts that are not hostile to it will pretty well fit into this formulation. And as thus formulated it appears to me to be a wholesome and useful technique for preventing distortion and misuse of the statute." 27/

Two other United States judicial anti-avoidance doctrines should be

mentioned. The first of these is the step transaction doctrine, under which a corporate adjustment is looked at as a whole. Even though it may consist of several steps, each of which considered alone would be tax free, the entire transaction will not be tax free if, as a whole, it does not meet the requirements of the statute. The doctrine is illustrated by the case of Helvering v. Elkhorn Coal Co. 28/ In that case Corporation M desired to acquire the operating assets of Corporation E but not its investments, which were substantial. E thereupon organized Corporation X to which it transferred all of the investment assets. X issued all of its stock to E, which distributed it to its shareholders. E then transferred its remaining assets to M for stock of M; E was dissolved and the M stock was distributed to E's shareholders. It was contended that each step in this transaction was tax free. The court held, however, that the transaction must be viewed as a whole, and that the transfer of E's operating properties to M was not tax free since it did not constitute the transfer of substantially all of E's properties, as the statute required.

The last doctrine, the economic approach to the consequences of transactions, has been applied in a number of situations to prevent tax avoidance. Briefly, the court has regard to economic considerations and not only to legal formalities such as contracts, property and so on, in order to distinguish "substance" from "form" or "sham" from "reality". In determining the reality or fictional character of a transaction—say, an indebtedness for interest payment or the ownership of a trust corpus—the court has adopted an economic test, rejecting legal tests of contract in the one case and property in the other. According to one commentator the economic approach by the courts has probably had its most important impact on the taxation of family income, particularly in the treatment of family trusts. For example, in one case the doctrine was used to defeat avoidance through the use of a short-term trust; the income from it was taxed to the grantor who retained powers of administration over the trust rather than to the beneficiary, the court refusing to recognize that the grantor ceased to be

the owner of the corpus after the trust was created. According to Hellerstein, "Reliance on economic factors to strike down tax avoidance is the broadest and the most elusive of the judicial barriers to tax avoidance that we have considered; and inevitably it has produced the widest variations in acceptance and application among the judges" 29/.

THE ATTITUDE OF THE LEGISLATURE TO TAX AVOIDANCE

Having regard to the established judicial approach to the interpretation and application of taxing statutes, action to counter tax avoidance must come primarily from the legislature. The approaches available to Parliament to correct avoidance may be divided conveniently into four types:

1. The "sniper" approach, which contemplates the enactment of specific provisions which identify with precision the type of transaction to be dealt with and prescribes with precision the tax consequences of such a transaction.

2. The "shotgun" approach, which contemplates the enactment of some general provision which imposes tax on transactions which are defined in a general way.

3. The "transaction not at arm's length" approach, which applies where the parties to particular types of transactions are not dealing with each other at arm's length and provides that the tax consequences will be different than they otherwise would be.

4. The "administrative control" approach, which contemplates the grant of wide powers to an official or an administrative tribunal in order to counter tax-avoidance transactions.

In its efforts to keep pace with the ingenuity and inventiveness of taxpayers bent on minimizing their tax liability, Parliament has enacted provisions which fall into all four categories. In some cases these efforts

have been too little and too late. In others they have gone beyond what was necessary and have penalized or inhibited bona fide transactions along with those which are reprehensible.

The "Sniper" Approach

Specific Provisions. Several provisions of the Income Tax Act are directed at particular types of avoidance transactions. For example, sections 21 and 22, dealing with intra-family transfers of property, are intended to avoid income splitting by property transfers to spouses and minors under 19 years of age.

Section 24 provides that where a security is received in satisfaction of an interest, dividend or other income debt, its value will be included in the recipient's income. The purpose of the section is to render inapplicable the doctrine that the giving of a promise to pay does not constitute payment, and to prevent the avoidance of taxation through the issuance of valuable securities in place of actual payment.

Another example of specific legislation aimed at tax avoidance is section 25 which deals with particular types of payments passing between an employer and an employee which, under the section, are deemed to be remuneration for services.

Other examples of the sniper approach to legislation against tax avoidance are contained in subsections (2) to (9b) inclusive of section 28 and section 105B, relating to payments of dividends out of designated surplus of a corporation.

Appraisal: Advantages. The advantages of the sniper approach may be summarized as follows:

First, it can be argued that a person's liability to pay taxes should be imposed in explicit terms and with the authority of Parliament; and that this precept is not observed where control of tax avoidance is maintained

through the use of some general declaration of principle governing tax avoidance and particularly where the application of the principle and the consequential tax adjustment is left to the discretion of the Department or some other body. If general or discretionary provisions are enacted, Parliament does not know when they will be applied or how far they may be extended.

Second, where specific anti-avoidance provisions are enacted they are relatively clear and certain in their application and they tend to produce certainty in the law. If they prove inadequate they can be amended.

The United Kingdom Royal Commission on the Taxation of Profits and Income explicitly rejected any departure from the system adopted under the United Kingdom Act of detailed legislative control of the various forms of tax avoidance. The Commission concluded that the specific provisions in the British law were adequate to deal with most forms of tax avoidance and that they had been supplemented by many court decisions. The Commission considered that in any event "avoidance is not a word of exact meaning or at any rate does not denote an activity that is in all contexts obnoxious".

Appraisal: Undesirable Features. First, since it is impossible to foresee every technique of tax avoidance, specific provisions can be effective only in so far as the legislators and the draftsmen can foresee the possible actions that might be taken by tax avoiders. Specific provisions in the Candian legislation have been far from totally effective in thwarting avoidance devices: "dividend-stripping" operations were carried on openly until the resort by Parliament to ministerial discretion in 1963; repeated amendments to the "associated corporations" provisions did not establish satisfactory control until the remedial legislation of 1963, invoking ministerial discretion; several "income-splitting" arrangements have slipped through the net of section 21. 30/

Second, legislation aimed at specific avoidance often opens new loop-holes. That is, particularization breeds avoidance. The significance of

this feature depends, of course, to a large extent on the skill of the draftsman. The following comment concerning the experience in the United States is interesting:

> "As the years rolled on and the Treasury and Congress awakened to the realization that avoidance was rife, the process of statutory amendment was adopted as a means of checking it; and there were enacted particular provisions to prevent specific types of avoidance. But...particularization in a statute leaves less room for the play of judicial interpretation and hence, while a particular device is eliminated, avoidance in general is not decreased. In other words, particularization reaches its immediate objective but gets no closer to the ultimate goal. It wins the battles but loses the wars. So while the legislators passed amendments right and left, they discovered that when they closed the dike in one place, they often used an implement which opened up a hole right next to it. Congress was fighting a losing battle until the Supreme Court came to its aid in the Gregory case. Taxpayers were becoming bolder and bolder, and, relying, with a confidence built up by earlier cases, on the doctrine that the law meant what it said, were pursuing every scheme that complied with the law as it read. Generally speaking, the lower courts justified this confidence, but with the Gregory decision the avoidance balloon was considerably deflated. Taxpayers discovered that no longer did safety lie in the literal meaning of the statute." 31/

Third, the sniper approach may result in inequity in circumstances where the draftsman, eager to catch all avoiders, casts the net very wide and thereby may reach situations never intended to be included. Yet the language of the statute is so specific that it is impossible for the court to afford relief through interpretation, for as the articulation of the statute increases, the room for interpretation must contract. Thus, section 139(5), (5a) to (5d) and (6), which specifically define persons who are deemed not to deal at arm's length, often apply to persons who in fact deal at arm's length, and in this way may well constitute a hardship. One commentator has described the difficulty and proposed a solution in the following terms:

> "The draftsmen of the statute, in their eagerness to catch the 'avoiders', have drawn within the range of the statute, no doubt unwittingly, situations which, when they are brought to light, were never intended to be included. Here perhaps is the worst feature of the present tendency toward particularity. Under the 1937 Act, many corporations engaged in trade or business, both domestic and foreign, and wholly legitimate in character, find themselves within the net of the personal holding company, and so face ruinous taxes. The language employed is so exact and specific that it is impossible to afford relief through interpretation. Thus the ultimate effect is to create greater

> inequalities, when the avowed purpose is to iron out inequalities.... But in the field of the so-called 'abuses'...it is suggested, although with some hesitation, that perhaps a sounder result may be obtained by the use of less particularity and more generality in language, even at the sacrifice of exactitude in the chart.... In this rather narrow field, might it not be advisable to give the Treasury and the courts somewhat more elastic language, language which will be susceptible of rational application in situations which are not foreseeable when the Act is drawn? On the one hand, this greater flexibility would tend to correct the so-called 'abuses' by deterring individuals from embarking on schemes which the very presence of such flexibility will render highly doubtful of success, and so too dangerous to attempt; and, on the other, would permit the exclusion from the punitive provisions of transactions which are quite proper and legitimate." 32/

Fourth, the use of highly particularized language aimed at specific avoidance devices assists the potential tax avoider "because it defines for him the obstacle that he must be ingenious to get around", said the United Kingdom Royal Commission on the Taxation of Profits and Income. The Commission was critical of the tendency of draftsmen, in order to meet this problem, to cast statutory provisions in language that is more and more vague and imprecise in the hope of covering some unforeseen situation—the very solution proposed in the third argument, supra, to meet the inequity and hardship discussed in that paragraph.

Fifth, anti-avoidance legislation is responsible for much of the obscurity in the Act, couched as such legislation often is in tortuous and obscure language of unrivalled complexity and difficulty. See, for example, subsections (5) to (6) inclusive of section 139, subsections (4) to (7) inclusive of section 39, subsections (2) to (9b) inclusive of section 28 and sections 105B, 105C and 139A. The United Kingdom Royal Commission recommended modification of the legislation "that will make it shorter, briefer and more precise". It would be easy to make the legislation shorter and briefer but it may be difficult to make it at the same time more precise.

The "Shotgun" Approach

The Use of General Provisions. Because of the impossibility of foreseeing all possible methods of avoidance, and perhaps also to obviate some of the

undesirable features of the "sniper" approach described above, Parliament has enacted a number of anti-avoidance provisions in general language which are not directed at any specific device or technique. The rationale for such general provisions was well stated in a recent Australian judgment:

> "It is perhaps inevitable in an acquisitive society that taxation is regarded as a burden from which those who are subject to it will seek to escape by any lawful means that may be found. This is generally called tax avoidance and it is successful if by reason of what is done what is potentially taxable is put outside the effective operation of the revenue laws. Furthermore, in the absence of a special law a genuine transaction does not lose its legal effect because it was carried out to avoid, limit or postpone tax. It is the recognition of this that accounts for the legislature casting its net wide to frustrate the attempts of those confronted with tax liabilities to get round the law. As often as a particular loophole is closed through which it has been discovered that revenue is lost, another is likely to be found, so that as long as it confines itself to stopping gaps the legislature is always a step behind reluctant taxpayers and their ingenious advisers. It is not, therefore, surprising that parliament has sometimes sought to anticipate tax avoidance by general laws rendering ineffectual against the Commissioner arrangements which are not shams but are entered into to avoid taxation obligations that would otherwise in due course be incurred." 33/

Section 16(1) of the Act provides that a payment or transfer of property made on the direction of a taxpayer or with his concurrence to some other person for the benefit of the taxpayer or as a benefit which he desired to have conferred on the other person, will be included in computing the taxpayer's income to the same extent as if it had been made to him. In our opinion this provision is clear in its intent and sufficiently general in its wording to allow the courts room for interpretation and application according to the circumstances in each case. A provision of this kind should be retained in the Act.

General anti-avoidance provisions in the Income Tax Act may be grouped into a number of classes or approaches which are discussed below.

The "Reasonableness" Test. A number of sections in the Income Tax Act sanction the recognition of certain transactions for tax purposes in so far as they are reasonable, regardless of their form or legal effect. For example, section 7(1) requires the inclusion in income of that part of a

payment under a contract that "...can reasonably be regarded as a payment of interest or other payment of an income nature". This provision was recently held applicable in the case of a sale of a farm where the price was higher than that paid for other farms in the area and was payable over eight years in instalments without interest 34/.

Section 11(1)(c) permits the deduction in computing income only of such an amount of an interest payment as is reasonable. Section 12(2) prohibits the deduction of an outlay or expense except to the extent that it was reasonable in the circumstances.

Section 20(6)(g) provides for the allocation of a price received partly for depreciable property of a prescribed class and partly for something else. It provides that the proceeds of disposition of the depreciable property are "the part of the amount that can reasonably be regarded as being the consideration for such disposition".

It will be observed that a number of these provisions relate to particular types of transactions or amounts. However, they depend for their operation on a general word, "reasonable", which leaves room for the exercise of judicial discretion. For this reason they may be classed as being within the "shotgun" approach rather than the "sniper" approach to legislation against tax avoidance.

The Undue and Artificial Reduction of Income. Section 137(1) provides that in computing income for the purposes of the Income Tax Act no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, if allowed, would "unduly" or "artificially" reduce the income. The section leaves the question of undue or artificial reduction of income to be finally determined by the courts, without providing any criterion by which to determine that question.

It is to be observed that the United Kingdom Royal Commission was critical of a British tax avoidance provision that struck at "artificial"

transactions and "artificial" operations. The Commission pointed out that "...a transaction is not well described as 'artificial' if it has valid legal consequences, unless some standard can be set up to establish what is 'natural' for the same purpose. Such standards are not readily discernible" 35/.

The precise scope and meaning of section 137(1) has not been clearly marked out by the courts, which have had few occasions to consider it. The Minister has relied successfully on the provision on at least three occasions 36/. In none of these cases has the meaning of "artificial" emerged with any clear meaning. In the Shulman case Ritchie, D. J. stated that: "In the context found here, 'artificially' means 'unnatural',—'opposed to natural' or 'not in accordance with normality'" 37/. It will be observed that unreasonable expenses are disallowed by section 12(2) of the Act. Expenses which are not incurred to earn income are disallowed by section 12(1)(a). Personal or living expenses are disallowed by section 12(1)(h). In view of these provisions and in view of the difficulty in determining what is artificial, it seems probable that section 137(1) would be held applicable only in rare and extreme cases. However, it may be useful as a deterrent and should be retained.

The Benefit Approach to Income. In several sections of the Act, a taxpayer is required to include in his income certain "benefits" or "advantages". For example, section 5(1)(a) includes as income from an office or employment the value of all benefits (with certain exceptions) received or enjoyed by the employee in the course of his employment. Section 8(1)(c) requires that a shareholder should include as income the value of a benefit or advantage (with certain exceptions) conferred on him by a corporation. Section 65(1) provides for the inclusion in income of the value of all benefits (other than a distribution or payment of capital) to a taxpayer during a taxation year "from or under a trust, estate, contract, arrangement or power of appointment".

Section 137(2) provides that every benefit conferred on a taxpayer as a result of one or more sales, exchanges, declarations of trust, or other transactions of any kind whatsoever will be regarded as a payment to the taxpayer equal to the amount of the benefit conferred. The value of the benefit may be taxed in a number of ways "depending upon the circumstances". It may be included in the income of the person receiving the benefit. If it is conferred on a non-resident it may be taxable under the provisions of Part III of the Act. Alternatively, it may be taxed as a gift under Part IV which relates to gift tax. Having thus imposed taxation on a very broad category of benefits, it is provided in section 137(3) that no benefit shall be considered to have been conferred if the parties were dealing at arm's length, if the transaction was bona fide and if several other conditions are met. Section 137(2) is stated to be applicable notwithstanding the form or legal effect of the transactions and whether or not there was an intention to avoid or evade taxes.

The language of this provision is far from clear. It is so broad and general that it would probably be held applicable only in extreme cases, and even then it would be difficult to determine what type of tax should be imposed. Its precise meaning must await interpretation by the courts which so far have had virtually no occasion to consider it. The section does not appear to have been significant in thwarting tax avoidance, although its deterrent effect is difficult to estimate.

The "Transaction Not at Arm's Length" Approach

It is an underlying assumption of income tax law that profits or gains made by a taxpayer can be measured in money terms and that such measurement is a proper basis for taxation because such profits or gains are achieved through the interplay of market forces which are independent of the taxpayer's control. In most cases this assumption is valid but it breaks down in circumstances where a taxpayer, either by himself or in collusion with others, is able to manipulate or control the forces which determine

his profits or gains and thereby bring about a reduction in his income below what it would otherwise have been. Tax avoidance of this nature is an ever-present problem and inevitably leads to a system of statutory and administrative rules designed to counteract such avoidance.

An important facet of the tax avoidance problem, which is particularly relevant in the field of business income, arises where the parties to a transaction do not have the customary opposing economic interests but have, by virtue of the particular relationship between them, a common economic interest which enables them to arrange the terms of the transaction to produce the least amount of tax. Persons in such circumstances are said not to deal with each other "at arm's length" and transactions between them are referred to as "transactions not at arm's length".

The Income Tax Act does not contain an all-inclusive definition of "arm's length" or "not at arm's length" as such. It is, however, provided in section 139(5) that "related persons" are conclusively deemed not to deal with each other at arm's length. "Related persons" include individuals related to each other (to the extent defined) by blood, marriage or adoption, a corporation and a person who controls it alone or together with other members of a related group, and corporations which are subject to common control. It is provided that if two parties are not related to each other it is a question of fact whether they are dealing with each other at arm's length. There is as yet no significant body of case law on the question whether unrelated persons are as a matter of fact dealing at arm's length. However, it does not appear that a mere mutual interest in keeping taxes to a minimum, in itself, constitutes evidence that parties are not dealing at arm's length.

Generally speaking, an object of the legislation should be to prevent avoidance of a tax liability by carrying out non-arm's-length transactions on terms different than those which would have prevailed between independent persons dealing at arm's length. However, it should be possible to carry

out some types of non-arm's-length transactions without tax consequences, where the objective is simply to achieve a change in form or organization without any real economic profit. This applies particularly where there is a technical reorganization within a group of related companies, where a proprietorship is incorporated and in certain types of transactions between related corporations. We discuss these cases in Chapter 15.

It is our hope and expectation that under the proposals which we are making for changes in the tax system there would be much less need than there is now for provisions dealing with transactions not at arm's length. We reach this conclusion because of a number of particular features of our proposals. Transactions within a family unit would be free of tax and the income received by all members of a family unit would be aggregated for taxation purposes. This would eliminate the need for some of the provisions or at least would reduce the scope of their application. Similarly, the right of related corporations to file consolidated returns would remove much of the incentive for such companies to arrange artificial transactions among themselves. The abolition of graduated rates for corporations would eliminate the need for the associated corporation provisions which are closely connected with the non-arm's-length provisions. Nevertheless, there will undoubtedly still be circumstances in which it would be necessary to legislate with respect to non-arm's-length transactions. This will be true particularly in the case of such transactions between residents of Canada and non-residents.

It is sometimes argued, and was urged before us, that the irrebuttable presumption that related persons do not deal with each other at arm's length is unjust, and that it should be open to taxpayers who are "related" within the statutory rules to demonstrate that as a matter of fact they are dealing at arm's length. In our view there should be an irrebuttable presumption that corporations which are subject to common control are not dealing with each other at arm's length. There should also be an irrebuttable presumption that a husband and wife who are living together are not dealing

with each other at arm's length and that they are not dealing at arm's length with their children, whether or not their children are living with them. However, it is our opinion that in the case of transactions between brothers and sisters who are not living with their parents and between brothers-in-law and sisters-in-law there should only be a presumption of not dealing at arm's length, which could be rebutted by evidence.

Broadly speaking, the present provisions of the Act dealing with non-arm's-length transactions fall into four categories: (1) those provisions which provide for the adjustment of the terms of transactions for tax purposes; (2) those provisions which do not adjust the terms of a transaction but charge with taxation the benefits or advantages that flow from it; (3) those provisions which for tax purposes ignore or look through a transaction so as to prevent or offset the artificial tax effect which would otherwise result from it; and (4) those provisions which affect the tax consequences of a situation by treating all persons not dealing at arm's length as if they were one person. We shall comment on each category in turn.

1. Section 17 contains provisions to the effect that where a taxpayer is a party to a non-arm's-length transaction he will be deemed to have received or to have paid the fair market value for goods or services. However, these provisions do not cover all possible circumstances. Subsection (1) provides that a taxpayer who has purchased anything in such a transaction at a price higher than the fair market value will be deemed to have paid the fair market value. Subsection (2) provides that where a taxpayer has sold anything in such a transaction for less than the fair market value he will be deemed to have received the fair market value. It will be observed that each of these subsections applies the fair market value test to one side of the transaction only, and the other party is not entitled to make an equivalent adjustment in his tax accounts. This would seem to unjustly penalize the parties to a transaction which is affected by subsection (1) or (2). Subsections

(5) and (6) provide that where property of a corporation has been appropriated to shareholders on the winding-up of the corporation or otherwise the corporation will be deemed to have received the fair market value of the property. Subsection (7) provides in effect that subsections (2), (5) and (6) are not applicable in respect of depreciable property which is specifically dealt with in section 20(4) (referred to below). Subsections (3) and (4) relate to rents, royalties and other payments for the use of property or for services where the transaction is between a resident taxpayer and a non-resident with whom the taxpayer does not deal at arm's length. There are no comparable provisions which apply to similar transactions between residents.

In our opinion provisions such as those contained in section 17 are desirable, subject to the following comments:

a) Where a transaction between persons not dealing at arm's length is adjusted for tax purposes to reflect fair market values or a test of reasonableness, such adjustments should be applied so as to achieve appropriate adjustment for each party, but not necessarily of equal amounts.

b) Provisions such as subsections (3) and (4) should apply to transactions between residents as well as to transactions between residents and non-residents. They should apply to the payer and the payee in all cases so that adjustments will be made consistently on both sides of the transaction.

c) The provisions should apply to gifts as well as sales. They should also apply where services are performed or property is made available without compensation, as well as where the compensation is too low or too high.

d) The provisions should not be applicable to transactions which would qualify as tax-free reorganizations or transfers.

2. The second category consists of provisions which impose tax upon benefits or advantages which flow from transactions not at arm's length. The most important provision of this kind is undoubtedly section 137(2), which is discussed above. As previously mentioned, this provision is so broad and general and so vague in its application that it is unlikely to have much practical importance. We believe it will be necessary to have provisions of this kind, but in our view they should specify with more particularity the circumstances in which they will apply. A provision relating to benefits or advantages conferred on non-residents should be kept separate from any provision or provisions relating to benefits received by residents.

3. The third category consists of provisions which for tax purposes ignore or look through a transaction so as to prevent or offset the artificial tax effect which would otherwise flow from it. An example of this type of provision is section 20(4), which contains rules for determining the capital cost and the undepreciated capital cost of depreciable property which is acquired by a taxpayer from someone with whom he does not deal at arm's length. The essential purpose and effect of these rules is to prevent the inflation of the cost basis of depreciable assets upon which capital cost allowance may be claimed. Although a non-taxable capital gain can be achieved by the vendor, if the value of the asset at the time of transfer can be shown to exceed its original cost, he is subject to recapture of depreciation if the price exceeds his undepreciated capital cost. Regardless of the price paid, the purchaser is not permitted to take into account for depreciation purposes any amount paid in excess of the original cost of the asset to the vendor, or to a previous owner if he did not deal with the vendor at arm's length. Furthermore, if the sale is made at a price less than the vendor's capital cost, the purchaser will be treated as having the same capital cost, so that if he later sells the property at a profit he will continue to be subject to recapture of the depreciation taken by the vendor.

Under our proposals it would not be possible for a vendor to make a tax-free capital gain on the sale of depreciable property. If the purchaser sold depreciable property at a profit, he would be subject to tax regardless of whether he had taken depreciation which was subject to recapture. For these reasons it seems to us unlikely that any provision such as section 20(4) would be required, except possibly during the transitional period immediately following the implementation of our proposals.

Another provision of the present Act which falls into our third category is section 23. It provides that where a right to income is transferred in a transaction not at arm's length, the income will continue to be taxed in the hands of the transferor unless the income is from property and the property is also transferred.

4. There are many provisions in the present Act which provide that two or more persons not dealing at arm's length shall be regarded for a particular purpose as if they were one person or one corporate entity. Some examples are sections 28(3), 62(3), 85 and 85A. Section 39(4) also falls into this category, although the test is whether corporations are "associated" rather than whether they deal with each other at arm's length. The purpose of such provisions is essentially to prevent or offset the tax effects of an artificial division of interests between closely related natural persons or among a number of corporations which they control.

As already indicated, we think that the problem of tax avoidance through transactions not at arm's length would be significantly reduced by the implementation of our principal recommendations. However, the problem will not be eliminated and it will be necessary to continue provisions which would prevent the distortion of income or the reduction of tax liability through transactions or arrangements between persons not dealing with each other at arm's length. It is not

practical to suggest in detail what the continuing provisions should be, because their nature and scope would depend on the legislative techniques and provisions which may be employed in giving effect to our recommendations.

The "Administrative Control" Approach

Specific Provisions. In several sections of the Income Tax Act the Minister of National Revenue has been given discretionary powers for a variety of purposes: to prevent income splitting through husband-and-wife partnerships (section 21(4)); to determine that a taxpayer's chief source of income is not farming or a combination of farming and another source of income (section 13(2)); and more recently, to make a direction that an amount received as part of a "dividend-stripping" transaction should be included in income or that two or more corporations should be deemed to be associated (section 138A). One of the conditions for making a direction under section 138A is that in the Minister's opinion one of the purposes or one of the main reasons for what the taxpayer did was the avoidance or reduction of taxes.

The provisions contained in sections 21(4) and 13(2) could just as well be dealt with by a legislative rule rather than by ministerial discretion. Section 138A was enacted as a temporary measure to halt tax avoidance practices which had become widespread and blatant. This was necessary since legislative amendments had proved inadequate. To some extent this was made inevitable by inconsistencies in the legislative scheme—the dual rate of tax for corporations, the exemption of inter-company dividends and the failure to tax capital gains.

In our opinion ministerial discretionary powers are undesirable except in extreme circumstances. Where such powers exist, taxpayers cannot be assured that they will be judged by the same standard as other taxpayers.

If an unfavourable decision is reached by the Minister, the taxpayer's rights of appeal are narrowly limited. Such a decision may have been reached privately and on the basis of evidence not communicated to the taxpayer. To the extent that discretionary powers are granted, there is a departure from the rule of law. For these reasons we think that ministerial discretion should be used in legislation only in unusual circumstances. This is discussed further in the Part of the Report dealing with Administration.

Section 138. The broadest power of administrative review is contained in section 138 of the Income Tax Act. This section seeks to meet the problem of tax avoidance through administrative action of the Canadian Treasury Board, subject to supervision by the courts. Subsection (1) provides that where the Treasury Board decides that one of the main purposes for a transaction or transactions effected before or after the coming into force of the Act was improper avoidance or reduction of taxes that might otherwise have become payable under the Act, that Board may give such directions as it considers appropriate to counteract the avoidance or reduction. Subsection (6) provides that an avoidance or reduction of taxes may be improper even if it is not illegal. Subsection (3) then provides that tax shall be assessed or reassessed and collected according to the directions of the Treasury Board notwithstanding any other provision of the Income Tax Act or any other Act.

The justification for the enactment of such a sweeping provision was explained by the Minister of Finance, Mr. Ilsley, when an earlier version of this provision was before Parliament. He stated:

> "For years the commissioner of income tax has advised that it is impossible to foresee or envisage the methods that will be adopted, and that the only possible way of dealing with the matter is to express general principles and leave it to some tribunal to decide.... Somebody has to be entrusted with the duty of watching these transactions, determining how much tax is avoided and whether the main purpose was to avoid taxation. If the main purpose was not to avoid taxation; if it was a legitimate business purpose, then the transaction should not be impugned.... Whatever

> jealousy parliament may have of the rights of the individual, parliament has to make sure that this economic system functions cleanly and justly and fairly, to the extent of its ability. I have perhaps given an impression that the practices I mentioned... are widespread. I do not think they are. But a few instances, known by a few individuals and passed from mouth to mouth, of skilful and wealthy individuals who legally are able to escape the clear spirit and intent of taxation legislation, will do more to discredit the system we live under and more to discredit the parliament that did not have the foresight to prevent these things, than almost anything you can think of; and I have come to the conclusion that we ought to strain a point here. We are at war. It may be that this would not be as necessary in time of peace....
> In the Victorian period the avoidance of taxation was a polite, gentlemanly game. Taxation was low, and if a taxpayer could find a hole in the law and crawl through it, everyone laughed about it and tried to block up the hole. But it did not make very much difference. If the crown could prevent his finding a hole, they would not get away with it. There was no moral interest involved. But when taxation becomes as heavy as it is to-day, when to a very great extent the people of this country are working for the state— and properly working for the state—then it is not an amusing matter, and is beyond the realm of a game. It becomes something— well, perhaps not exactly treason, but something considered most unpatriotic and unsocial....
> As I have said, if we make it as definite as we ought to make it for the guidance of a court we will be so definite that other ways will be found to get around it. Therefore it must be pretty wide, and there must be some discretionary powers in the tribunal making the decision." 38/

Section 138 has never been interpreted by the courts, so that its precise meaning is uncertain. Certainly it gives rise to many difficult questions. It empowers the Board to designate a perfectly legal transaction as improper from a taxation standpoint, but contains no standards or guide-posts by which impropriety is to be determined. It empowers the Board to give such directions as it thinks appropriate to counteract the avoidance or reduction, but what form those directions might take and against whom they might be made is not clear. Subsection (5) provides for judicial review of the actions of the Treasury Board, but little guidance is given as to the grounds for such review. Another question that emerges from this provision is how the Board is to determine whether one of the main purposes of a transaction was the improper avoidance or reduction of taxes. An investigation into the subjective purposes lying behind a business transaction or series of transactions is at least a highly speculative undertaking.

Section 138 may be open to the criticism that it violates the most fundamental common law concept regarding taxation—that taxing legislation must impose a tax in clear and unambiguous language and the taxpayer is free from taxation unless he comes within the letter of the law. It also offends the principle that the rules on which tax is imposed should not be changed retroactively. Businessmen object to this type of legislation because it interferes with business planning and management. Indeed, it has been said 39/ that "it casts a continuing cloud on legitimate transactions and prevents finality"; "put in the hands of a vindictive administration...it could be used vindictively"; it is "pure autocracy" to make a man pay taxes when he is not within the law. When section 138 was first before Parliament, the Minister of Finance, Mr. Abbott, assured the objectors that the power had only been used four times in the five years which had elapsed since its inception in 1943 and emphasized the large sums of money and the barefaced type of avoidance involved in those cases.

And yet if it is beyond the ability of the draftsman to fashion effective, specific anti-avoidance provisions which will pass the judicial test of strict, literal construction, as not infrequently seems to happen, it is not surprising, for reasons advanced by Mr. Ilsley, that the government occasionally resorts to administrative discretion. However, experience with section 138 has shown that where the discretion is given to a body such as the Treasury Board it is hardly ever used.

Some general anti-avoidance provisions which are somewhat similar to section 138 have been enacted in other countries. These are discussed below.

United Kingdom. Parliament adopted a general tax-avoidance provision in relation to profits tax 40/. It provided that where the Commissioners of Inland Revenue were of the opinion that the main purpose or one of the main purposes of a transaction was the avoidance of liability to profits tax, they could direct adjustments of liability to profits tax so as to counteract

the avoidance of liability. If it appeared in certain specified types of transactions that the main benefit which might have been expected to accrue within the subsequent three years was the avoidance of liability to profits tax, the avoidance of liability was deemed to have been the main purpose or one of the main purposes of the transaction. The test to be applied was the objective test: would a reasonable man in fact expect that the main benefit which would accrue from the transaction would be the avoidance of tax? It was provided that the particulars of a proposed transaction could be furnished to the Commissioners and if the Commissioners were satisfied that the transaction would be "entered into for bona fide commercial reasons" they could give a binding notification that the section was not applicable.

The United Kingdom Royal Commission on the Taxation of Profits and Income gave its approval to this provision, having regard to the fact that because of the form and structure of profits tax it would be too easy for a corporation to arrange its affairs so as to reduce its liability to tax very materially without any alteration in the substance of its position or the position of its proprietors. Said the Commission:

> "We do not think that there is any serious criticism to be made of the form of the section. Subsection (3) deals with the difficult question of motive or purpose and it imputes the purpose of avoidance summarily where certain specified conditions are found to exist. But the imputation only arises from the objective test of discovering what was the main benefit that might have been expected to accrue from a given transaction. That does not seem to us materially different from saying that a man's motives are to be inferred from the probable consequence of his actions. There are circumstances in which that principle is a better test of motive than can be afforded by his own answers some time after the event. It should be added that the section does contain a provision enabling the Board to exempt a transaction altogether if they are satisfied that it was entered into for bona fide commercial reasons and that it ought not to be brought under the section." 41/

The Netherlands. The Netherlands has a general anti-avoidance provision which runs as follows:

> "In the assessment of the direct State taxes, legal transactions are not taken into account if it must be assumed—by reason of the

> fact that they have not aimed at a material modification of the existing circumstances or by reason of other specific acts or circumstances—that they would not have been entered into but for the fact that liability for any of the said taxes, in the event of it having been applied or being likely to be applied, would be avoided either in whole or in part for the future." 42/

Australia. In Australia an attempt has been made to control avoidance by a very general measure passed by the Commonwealth Legislature 43/. That section provides:

> "260. Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly—
> (a) altering the incidence of any income tax;
> (b) relieving any person from liability to pay any income tax or make any return;
> (c) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or
> (d) preventing the operation of this Act in any respect,
> be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose."

The section was held by the Privy Council to be applicable to a complicated dividend-stripping operation 44/. In seeking to apply the section, Lord Denning held that the Court must see whether the arrangement itself discloses the purpose or effect of avoiding tax irrespective of the motives of the persons behind the plan. That is to say, the court must be able to predicate—by looking at the overt acts by which the arrangement is implemented—that it was implemented in that particular way so as to avoid tax. If the court cannot so predicate but has to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, they are not within the section. The section will apply if one of the purposes was to avoid tax—tax avoidance need not be the sole purpose.

Section 260 has been criticized as being an "annihilating" provision only. That is to say, it has no further or other operation than to eliminate from consideration for tax purposes such contracts, agreements and

arrangements as fall within the description it contains. It does not, however, confer on the Commissioner the power to reconstruct transactions. Thus, to invalidate for tax purposes the transaction into which the taxpayer in fact entered is not enough to impose upon him a liability which could only arise out of another transaction into which he might have entered but in fact did not enter 45/.

SUMMARY

1. It is necessary and desirable in any modern tax system to have effective provisions to counteract tax avoidance. However, a number of other objectives and guiding principles must also be kept in mind.

   a) A taxpayer should not be penalized for deciding not to earn income, even if the reason for this decision is the reduction or avoidance of tax liability. Likewise, if he gives up a right to income and does not retain any control over the income or the source of income he should not be taxed on such income arising thereafter.

   b) If a taxpayer arranges his affairs in such a way that he avoids tax on income or reduces his liability for tax on the income below what he would expect to pay under the general scheme and intent of the legislation, while continuing to enjoy the benefits of the income or continuing to control the income or its source, he should be taxed on the income.

2. The courts should not depart lightly from the words of the statute where those words are clear and unambiguous and should not disregard the legal effect of a transaction. However, in order to work with the legislature to develop good tax laws and in order to avoid the necessity for numerous technical loophole-closing amendments, the courts should interpret the tax statute fairly and equitably and in such a way as to give effect to the legislative scheme, without any

presumption being made either for or against the taxpayer. They should also have regard to the true nature and effect of transactions and take into account their economic substance as well as their legal effect.

3. Tax avoidance provisions in the legislation should be carefully designed to accomplish the objectives in paragraph 1 above so far as possible. While the "sniper" approach or the "shotgun" approach or an approach somewhere in between may be advisable in each area, the provisions should not be so broad or so rigid as to penalize bona fide transactions. Normally a provision should be expressed in sufficiently general terms that the courts will be able to interpret the words in the context of the legislative scheme and distinguish between the cases which are deserving of correction and those which are not. On the other hand, such provisions should not be so broad and general that they are devoid of any clear meaning and therefore ineffective in operation.

4. While non-arm's-length provisions will be less important under our proposals, they will still be necessary to deal with some matters, particularly transactions between residents and non-residents. The present irrebuttable presumption as to non-arm's-length dealing should continue to apply as between corporations which are subject to common control, as between a husband and wife who are living together and as between them and their children, whether or not their children are living with them. However, there should only be a rebuttable presumption that brothers, sisters, brothers-in-law and sisters-in-law are not dealing with one another at arm's length.

5. Where a sale takes place between persons not dealing with each other at arm's length at a price other than fair market value, the price should be adjusted to fair market value in the tax accounts of both parties and for all purposes of the legislation. There should be

similar provisions to the effect that where a person renders services to, or makes property available for use by another person with whom he does not deal at arm's length, each party will be considered to have paid or received a reasonable remuneration, rent or royalty. These provisions would not apply to transactions which qualify as tax-free reorganizations or transfers or to transactions between members of a family unit.

6. Section 137(1), which disallows expenses which would unduly or artificially reduce income, would probably be held applicable only in rare and extreme cases, and should be retained mainly as a deterrent. Section 137(2), which imposes tax on benefits conferred, is so broad and general and so vague that it is unlikely to have much practical importance. Any provision of this kind should specify more particularly the circumstances in which it will apply.

7. Section 16(1), which provides for the constructive receipt by one taxpayer of a payment made to another, is sufficiently clear in its intent and at the same time is sufficiently general in its wording that it leaves room for interpretation and application by the courts according to the circumstances of each case, and it should be retained.

8. Discretionary powers should be granted to the Minister only in unusual and extreme circumstances.

REFERENCES

1/ Royal Commission on the Taxation of Profits and Income, Final Report, Cmd. 9474, London: H.M.S.O., 1955, para. 1016.

2/ Ibid.

3/ Ibid., para. 1017.

4/ Ibid., para. 1019.

5/ (1869) L.R. 4 H.L. 100, p. 122.

6/ Versailles Sweets Limited v. Attorney General of Canada, [1924] S.C.R. 466, p. 468, and M.N.R. v. Sheldon's Engineering Limited, [1955] S.C.R. 637, p. 645.

7/ G. S. A. Wheatcroft, "The Attitude of the Legislature and the Courts to Tax Avoidance", (1955) 18 Mod. L. Rev. 209, p. 215.

8/ [1954] Ex. C.R. 181.

9/ Section 22(3).

10/ [1960] S.C.R. 606.

11/ [1965] Ex. C.R. 676.

12/ See, for example, Hargal Oils Limited v. M.N.R. [1965] S.C.R. 291.

13/ [1936] A.C. 1, pp. 19-20.

14/ See, for example, Seven Up of Montreal Limited v. M.N.R., [1952] Ex. C.R. 288; Canada Safeway Limited v. M.N.R., [1957] S.C.R. 717; and Bell v. M.N.R., 62 DTC 1155 (Exchequer Court).

15/ [1936] A.C. 1, p. 21.

16/ [1960] Ex. C.R. 350.

17/ See also M.N.R. v. Shields, [1963] Ex. C.R. 91.

18/ [1943] A.C. 377, p. 381.

19/ [1949] 1 All E.R. 1108, p. 1120.

20/ (1923) 263 U.S. 179.

21/ (1917) 245 U.S. 151, p. 153.

22/ (1938) 305 U.S. 281, p. 292.

23/ (1873) 17 Wall. 496 (United States Supreme Court).

24/ Ibid., p. 506.

25/ (1935) 293 U.S. 465.

26/ 270 F. 2d 294, p. 297 (3rd Cir. 1959).

27/ J. R. Hellerstein, "Judicial Approaches to Tax Avoidance", 1964 Tax Conference Report 55, pp. 65-66.

28/ 95 F. 2d 732 (4th Cir. 1938).

29/ Op. cit., p. 73.

30/ For example, M.N.R. v. MacInnes, supra; in Robins v. M.N.R., [1963] Ex. C.R. 171, the transfer of a business was held not to be a transfer of property within the meaning of section 21.

31/ H. J. Rudick, "The Problem of Personal Income Tax Avoidance", (1940) 7 Law and Contemporary Problems 243, pp. 246-47.

32/ M. B. Angell, "Tax Evasion and Tax Avoidance", (1938) 38 Columbia Law Review 80, pp. 93-94.

33/ Per Menzies J. in Peate v. Commissioner of Taxation, (1962) 36 A.L.J.R. 258, p. 259.

34/ M.N.R. v. Groulx, 66 DTC 5126 (Exchequer Court, reversing a decision of the Tax Appeal Board).

35/ Op. cit., para. 1024.

36/ Shulman v. M.N.R., [1961] Ex. C.R. 410 (an appeal to the Supreme Court of Canada was dismissed without written reasons); Rivershore Investments Limited v. M.N.R., [1964] Ex. C.R. 481; and Harris v. M.N.R., 66 DTC 5189.

37/ [1961] Ex. C.R. 410, p. 425.

38/ House of Commons Debates, April 15, 16, 1943, Vol. 3, pp. 2232, 2254-55.

39/ Standing Committee, Banking and Commerce, House of Commons, 1948, p. 690 et seq.

40/ The Finance Act, 1951, c. 43, section 32. Profits tax was abolished by the Finance Act, 1965, c. 25.

41/ Op. cit., para. 1034.

42/ Article 1 of The Netherlands Law (29th April 1925), for the Promotion of the Correct Assessment of Direct Taxes.

43/ Section 260 of the Income Tax and Social Services Contribution Assessment Act, 1936-1966.

44/ Newton v. Commissioner of Taxation of the Commonwealth of Australia [1958] A.C. 450.

45/ See Clarke v. Federal Commissioner of Taxation, (1932) 48 C.L.R. 56, p. 77; see also an article by H.A.J. Ford, "Legislation Against Tax Avoidance: The Australian Experience", [1961] British Tax Review 247, p. 257.

APPENDIX B

ESTIMATED GROWTH OF PENSION PLAN CONTRIBUTIONS AND ASSETS, AND THE TAX DEFERMENT INVOLVED

Based on the material contained in two surveys, 1/ it is estimated that during 1960 pension funds received more than $200 million in investment income and paid out approximately the same amount in benefits and withdrawals. In the three years following 1960, the number of employees covered by pension plans increased by approximately 20 per cent, the total assets under administration grew by over 40 per cent, and total employer and employee contributions, including contributions to federal and provincial government plans, increased to a rate exceeding $1 billion a year. At the end of 1963, the total market value of invested assets held by pension plans exceeded $7.5 billion, with trusteed pension plans holding approximately 70 per cent of the total assets and life insurance group annuities making up somewhat under 25 per cent of the total assets. The balance was represented by federal government group annuities. No figures are available to indicate the value of assets that have been built up in individual registered retirement savings plans because no annual reporting is required. However, by the end of 1964 over $260 million 2/ of deductions had been reported by individuals, and total assets held would probably exceed that amount.

It is difficult to project trends in this area. Although the Canada Pension Plan might slow the rate of growth of private plans, it should mean an increase in the rate of contributions and asset growth of total retirement income funds. In addition, some provincial governments (effective in Ontario in 1965, Quebec in 1966 and Alberta in 1967) have introduced solvency requirements that will mean that the growth of employer contributions and of assets will accelerate. Such an increase might also be expected to follow from our recommendations that property gains realized outside of registered plans should be taxable in full at the time of receipt, and that the gross-up and credit procedure for corporate tax should be applicable to registered plans. It would also be expected that the increased relative value of the tax deferment on property income received

by registered plans would cause taxpayers with incomes exceeding $10,000 to increase their deductible contributions above the 1964 rate of almost 3 per cent of total income 3/. The rate for incomes under $10,000 in 1964 was just under 2 per cent, 3/ a level for private plans that may not increase because the Canada Pension Plan will have a major impact on this group. Even with a decline in the present rate of growth of private plans with the Canada Pension Plan in operation, it would seem reasonable to assume a growth rate of 10 per cent a year, as compared to the over 11 per cent a year for recent years. (See Table B-1.) On this assumption it could be expected that by 1970, amounts of the following magnitude would be attained:

Assets	$16.5 billion
Annual contributions (employer and employee)	1.7 billion
Annual investment income	0.9 billion
Annual pension payments and cash withdrawals	0.8 billion

In addition, the Canada and Quebec pension plans will have accumulated at least $3 billion in assets, and contributions to those plans will be at an annual level of approximately $0.7 billion. Thus by 1970, assuming that the total of these amounts will be eligible for preferential tax treatment, the total amount of income on which tax could be postponed until retirement, including both employer and employee contributions and investment income, will have reached a level of nearly $3.5 billion a year, more than double the level in 1964, or about 7 per cent of total personal income as compared to over 4 per cent in 1964. Taxable income of individuals is currently less than 40 per cent of personal income, so this could mean tax postponement for some 17 per cent of taxable income. Assuming an average rate of tax of 20 per cent on the amount postponed, there would be a postponement of nearly $700 million of taxes for the year 1970, a postponement that would be offset to the extent of about 30 per cent by tax on pension benefits brought into the income of taxpayers in that year. Part of this

amount would represent taxes forgone rather than postponed, if marginal rates for the individual were lower when pensions were received than when contributions were made.

TABLE B-1

SELECTED DATA FOR LIFE INSURANCE COMPANIES GROUP ANNUITIES, FEDERAL GOVERNMENT GROUP ANNUITIES, AND TRUSTEED PENSION FUNDS, 1957-64

(1) Year	(2) Number of Plans a/	(3) Number of Employees	(4) Total Contributions b/ (millions of dollars)	(5) Total Assets c/ (millions of dollars)	(6) Percentage Increase in Column (5) Over Prior Year a/
1957	6,381	1,365,238	430	3,836	
1958	7,366	1,553,789	512	4,340	13.1
1959	8,404	1,633,161	567	4,822	11.1
1960	9,260	1,658,963	569	5,424	12.5
1961	10,181	1,755,706	618	6,081	12.1
1962	11,260	1,828,497	664	6,804	11.9
1963	12,446	1,973,559	732	7,616	11.9
1964	13,479	2,056,493	814	8,484	11.4

Notes: a/ Not all of the annual increase is a reflection of growth, because the coverage of the survey increased slightly in the early years. Also, the survey is not complete because not all pension plans are covered. The above figures do not include the armed forces, the federal public service, seven of the provincial civil services, and three of the provincial teachers' funds. These groups are excluded because no separate invested funds are maintained for them.

b/ Employer and employee.

c/ At book value at the end of the year.

Source: Dominion Bureau of Statistics, Trusteed Pension Plans, Financial Statistics, Ottawa: Queen's Printer, for the years 1957, 1959 and 1964, Table D.

TABLE B-2

SELECTED DATA FOR PENSION PLANS FOR 1960

Number of Plans a/	8,920
Number of Members	1,815,022
Eligible Employees who Elected not to Join	284,519
Ineligible Employees of Employers Having Plans	573,183
Proportion of Covered Employees who are Members of a Contributory Plan	82 per cent
Proportion of Covered Employees with Unit Benefit Plans b/	75 per cent
Proportion of Covered Employees with Plans Having some Vesting Rights	69 per cent
Employee Contributions c/	$334,751,777
Employer Contributions	$467,129,485
Number of Retirements During the Year	19,116

Notes: a/ This table includes the pension plans covered by Table B-1 and also the pension plans which are listed in note a/ to to that table as being excluded therefrom. Neither table covers privately operated plans which are unfunded.

b/ A unit benefit plan is a plan which contains a formula for determining the amount of each member's pension. It is to be distinguished from a money purchase plan or a profit sharing plan under which the pension is whatever the contributions will provide.

c/ Most of the difference between this figure and the amount reported in Taxation Statistics (shown in Table B-3) can be accounted for by profit sharing pension plans, unfunded plans for provincial civil servants and teachers and individual retirement savings plans that are not included in the above statistics. In addition, this figure includes some non-registered plans that do not appear in Taxation Statistics.

Source: Dominion Bureau of Statistics, Pension Plans, Non-financial Statistics, Ottawa: Queen's Printer, 1960.

TABLE B-3

PENSION AND RETIREMENT SAVINGS PLAN CONTRIBUTIONS
REPORTED BY INDIVIDUALS WITH TAXABLE RETURNS, 1957-64

(1) Year	(2) Individuals' Contributions a/ (millions of dollars)	(3) Taxable Income of All Individual Taxpayers (millions of dollars)	(4) Percentage (2) to (3)
1957	247.3	7,906	3.13
1958	278.2	8,145	3.42
1959	311.3	8,954	3.48
1960	354.0	9,727	3.64
1961	393.0	10,423	3.77
1962	420.1	11,108	3.78
1963	467.6	12,220	3.83
1964	519.7	14,172	3.67

Note: a/ Includes past service contributions.

Source: Department of National Revenue, Taxation Statistics, Ottawa, Queen's Printer, covering the years indicated.

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1/ Dominion Bureau of Statistics, Pension Plans, Non-financial Statistics, Ottawa: Queen's Printer, 1960, p. 11, and Pension Commission of Ontario, Pension Plans in Ontario Statistics, Toronto: Queen's Printer, 1963, p. 4.

2/ Total of amounts reported as deductions by individuals in Department of National Revenue, Taxation Statistics, Ottawa: Queen's Printer, for the years 1958 to 1964.

3/ Estimated from Department of National Revenue, Taxation Statistics, Ottawa: Queen's Printer, 1966.

APPENDIX C

ALTERNATIVE PROCEDURES FOR THE TAXATION OF INCOME RECEIVED THROUGH LIFE INSURANCE

The feasibility of the recommendation outlined in Chapter 16 with respect to the taxation of property income accumulated for the benefit of standard life insurance policyholders depends on finding a procedure which is satisfactory from the points of view of both equity and ease of computation for allocating to individual policyholders the investment income credited to policy reserves. Because the recommendation does not visualize that initially there should be taken into account in computing income the difference between policy proceeds and the total of premiums paid and investment earnings accumulated (a difference that is essentially the mortality gain or loss), the actual gain realized by the policyholder over the life of the policy would not necessarily be equal to the investment income that would be taxed. If mortality gains and losses were taken into account in computing income, the only inequity that could result from the arbitrary allocation procedures would relate to the time at which the income was and should have been brought into account. Without the balancing procedure of ultimately bringing into the computation of income the net difference between the policy proceeds and the premiums paid plus investment income already included in income, it would be necessary to rely entirely upon the allocation procedure to determine equitably the income that should be taxed to the policyholder.

If, however, our assumption that a satisfactory procedure can be developed for such allocation proves to be incorrect, one of the following alternatives should be adopted. These are alternatives to the taxation of policyholders on the investment income credited to policy reserves.

Alternative 1. Inclusion of Mortality Gains and Losses in the Computation of Income

Under this alternative, mortality gains and losses would be taken into account in the computation of income. It would be extremely simple to

administer because it would not require any allocation of investment earnings to individual policyholders. The approach would be to levy a flat-rate, non-refundable tax of, say, 15 per cent, on the aggregate amount of investment income credited each year to policy reserves and, when the policy proceeds were received, to bring into the tax base of the policyholder the excess or deficiency of the policy proceeds over the premiums paid, or the excess over the net premiums paid if some adjustment was to be made for the service costs of obtaining the protection. As an alternative to using the net premiums in the computation, the total premiums paid might be deducted from the policy proceeds and only the net gain brought into income, with no deduction when premiums paid exceeded the amount of the proceeds.

The flat-rate tax levied on the investment income would in effect be a postponement fee assessed to compensate for the deferment of tax on the property income from the time it was earned until it was paid to the policyholder as part of his policy benefits. The rate suggested is relatively high because the value of the deferment would be substantial. Policy dividends would still be included in income, but the only significance of such treatment would be timing; if they were excluded from income they should be deducted from premiums paid in computing the net premiums, a procedure that would increase the portion of the policy proceeds that would ultimately be taxable.

This alternative has the advantage of producing some tax revenues from the property income accumulated each year, while avoiding the administrative problems of a detailed allocation to each policyholder. However, it would also raise some initial difficulties because all the policies outstanding at the date the new legislation became effective would have to be valued. This, of course, is a problem that would arise under any proposal that involved the taxation of mortality gains. However, this valuation would be made by the insurer under regulations developed by the industry and the government departments concerned, so that the individual policyholder would not have to make any computations.

This alternative would have some impact on the insurer. A tax on policyholder investment income should bear on the individual and should, in principle, have no effect on the insurer. However, if the tax on the investment income credited to policy reserves was collected at the insurer level in the form of a postponement fee, or for that matter as a withholding tax, then the amount of funds available to the insurer for investment would be reduced. This would in turn moderately reduce the amount of investment earnings in respect of policies currently outstanding and might, at least to some extent, be a cost to the insurer. In the case of policies issued subsequent to the effective date of a change in tax treatment, the level of premiums could be increased to reflect the imposition of the tax. In addition, the position of the insurer with respect to outstanding policies would be protected if policy liabilities were related to the level of net investment earnings or if the policy was a participating one so that the "cost" of the diminished investment yield could be passed on through reduced policy dividends. In these cases the current policyholder would have to absorb both the direct and indirect impact of the tax. However, in the case of non-participating policies that were outstanding at the time the tax was imposed, the insurer would have to absorb any indirect effect of a tax collected at the insurer level. The impact on the insurer of a tax on income which was allocable to the older policies would be somewhat mitigated by the fact that investment earnings have increased substantially in recent years 1/. However, in the case of more recent policies, the imposition of such a tax could have an unfavourable impact on the income of the insurer. Therefore, a relieving provision applicable to non-participating policies issued in recent years should be implemented if this alternative were adopted. The purpose of the provision would be to compensate the insurer, at least partially, for the decline in his net investment earnings brought about by the imposition of the tax. For example, a postponement fee or tax might be applied at reducing rates to the investment income allocable to such policies, with the lowest rate applying to the most recent policies.

A flat-rate tax would be inequitable to the policyholders to the extent that it did not reflect the progressive nature of our recommended tax system. Thus, a tax imposed at a moderate rate as a fee for postponement of the personal tax would leave a substantial deferment advantage to the higher income policyholder, but would be unduly high for the non-taxable or very low income policyholder. One method of meeting this problem would be to impose tax at a higher rate and then to allow the beneficiary a tax credit on the policy proceeds. This would be of greater relative value to the low income beneficiary.

In principle, any postponement fee should apply only to investment earnings that were applicable to Canadian residents but, because investment earnings of non-residents would in general be subject to a withholding tax, it would be reasonable to levy the postponement fee in lieu of such tax on all the investment earnings arising from business effected in Canada. However, the fee should not apply to income derived from the foreign operations of Canadian insurers.

Alternative 2. Withholding Tax on Investment Income Credited to Policy Reserves

Under this alternative, mortality gains and losses would not be taken into account in computing income, but would cause some administrative complexities because investment earnings would have to be allocated to individual policyholders when benefits became payable under a policy. The approach would be to levy a withholding tax on investment income credited by the insurer to the policy reserves 2/. When any policy benefits on maturity or termination were paid out, the accumulated investment income attributable to the policyholder would be computed and included in his income. The withholding tax would be deducted from the policy proceeds when they were paid and the policyholder would be given credit for the tax withheld on his behalf. The administrative difficulties of allocating property income to policyholders should be less than for the allocation proposed in

Chapter 16, because the allocation would have to be made only when the policy proceeds were payable rather than each year. The regulations could stipulate one method of allocation, and provide that any reasonable alternative method approved by the Department of Insurance could be employed.

The rate of withholding should be close to the average rate of tax applicable to the beneficiaries, say, 30 per cent, in view of the extended time period before it would be possible for the lower income beneficiary to claim a refund.

Under this alternative it would also be a simple matter for mortality gains and losses to be taken into account in computing income. Thus, the policyholder could be taxed either on the investment income portion of his policy proceeds, or on the total proceeds less premiums paid. In either case, he would receive credit for the withholding tax deducted from the investment income portion.

If mortality gains and losses were to be taken into account in computing income, the administrative procedures would not be as simple as under the postponement fee alternative discussed above. The tax on the investment earnings accumulated in policy reserves would be withheld each year, while the withholding tax on the mortality gain, if any, would be remitted at the time the policy proceeds were paid. In the event of a mortality loss, the insurer would claim a refund of all or a portion of the taxes withheld on the investment income accumulated for the same policy. Hence, the policyholder would receive the proceeds less 30 per cent of the excess of the proceeds over the premiums paid. The full amount of the proceeds would be taken into account in computing his income and he would receive a refundable tax credit for the 30 per cent of the income portion, if any, which was withheld by the insurer.

REFERENCES

1/ The rate of investment income earned by insurance companies has increased in every year but one since 1948 and now stands at a level 55 per cent above what it was in that year. Accordingly, a serious problem would only arise on older policies if interest rates should decline. To meet such a possibility it should be provided that the postponement fee applicable to non-participating policies outstanding at the date the law became effective should not reduce the rate of net property income in respect of such policies, including property gains and losses, below, say, 5 per cent. This would mitigate the impact of this tax on insurers if rates of investment earnings should decline.

2/ Alternatively, a postponement fee approach along the lines outlined under the first alternative could be utilized instead of a withholding tax. The lower level of a postponement fee would reduce the impact on the insurer, but the necessity of allocating investment income to the policyholder at the time the proceeds were paid would remain unless mortality gains and losses were taken into account in computing income.

APPENDIX D

ALTERNATIVE METHODS OF TAXING GIFTS

There are several ways of taxing transfers of wealth, and in reaching a conclusion on the best method for the Canadian tax system, we considered, in some detail, the following main methods:

1. The present method of taxing estates and gifts.
2. An integrated transfer tax.
3. An accessions tax.
4. A succession duty or inheritance tax.
5. A net wealth tax.

PRESENT METHOD

Conformity to Economic and Social Objectives

The present estate and gift taxes do not tax according to ability to pay as we have defined it. In our opinion, the preservation of the integrity of the new tax base would alone require the repeal of these taxes. Furthermore, the present taxes are not fully integrated so as to preserve the progressiveness of the rates. For example, gifts made over a lifetime are not aggregated to determine the rates at which either the gift tax or the estate tax is levied 1/. The estate tax does aggregate the whole of a man's estate at death and bring into tax completed gifts made within three years of death. This would be a valid method of aggregation if reduction in the rate of accumulation of wealth by means of transfers between generations was the sole objective, but it conflicts seriously with our concept of ability to pay.

Another major defect of the present taxes is the ease with which estate taxes may be avoided altogether. Because of the very generous annual gift tax exemption, which rises with income, a planned programme of annual gifts enables large amounts to be distributed over a period of time on payment of little or no tax 2/.

The wealthier a man is the more likely he is to have disposable wealth with which to implement a planned programme of inter vivos gifts. The relatively low rates of gift tax encourage such giving, but because the tax is imposed on the donor there is no advantage in distributing gifts widely. Accordingly, the present system may be described as neutral in encouraging or discouraging accumulations of wealth.

Fairness of the Tax

The present estate and gift taxes are subject to a number of defects which result in their being inequitable and in their failing to attain the objectives we consider desirable. The failure to aggregate adequately reduces progressiveness relative to other parts of the tax system, thus shifting part of the total tax burden in an arbitrary way from those who receive gifts to those who do not. The types of exemption and the ease of avoidance favour high income and large wealth groups. For example, an individual earning more than the amount of his personal deduction of $1,000 will pay at least 11 per cent income tax plus 4 per cent old age security tax up to the specified maximum on the excess, while another individual can receive $4,000 free of tax, and up to $10,000 more that is taxable at the lowest gift tax rate of 11 per cent, regardless of his own personal income tax rate.

Another major source of inequity and confusion is the inconsistent treatment of gifts. An inter vivos gift may be treated as incomplete under the estate tax and is therefore added to the donor's estate; it may be treated as complete for gift tax purposes, so that gift tax is levied on the donor, and, depending on circumstances, it may be treated as complete or incomplete under the income tax for the purpose of taxing the income from the gift. For example, if a donor transferred securities in trust for his children, reserving an annuity to himself in the event of his infirmity, the transfer to the trust would be treated as a completed gift of a beneficial interest in the trust for gift tax purposes and would be taxed

immediately. However, under special provisions of the Estate Tax Act, 3/ the value of the property less the value of the annuity payments made over and above what the property could be expected to yield at 5 per cent would be taxed as part of the estate of the donor. Under the Income Tax Act the income, though received by the beneficiaries, would be taxed to the donor if the children were under 19. If they were over 19, the income would be taxed in the hands of the children 4/. If the donor reserved a reversionary right in himself in the event that any of the beneficiaries should predecease him, the income of the trust would be attributable to him in any event 5/.

Under the proposed integration of gifts into the comprehensive tax base, one set of rules would determine whether a given transfer was a completed gift or not 6/.

AN INTEGRATED TRANSFER TAX

An integrated transfer tax would eliminate for tax purposes the present distinctions between inter vivos gifts, which are taxed under the gift tax provisions of the Income Tax Act, and testamentary gifts, which are taxed under the Estate Tax Act. It would be levied at rates which were based on the amounts given by the donor and so would differ from an accessions tax, which would be imposed at rates dependent on the amount of gifts received from all sources by each donee.

The easiest approach to integration would be to retain the two present taxes but to adopt a common rate schedule that was the same as, or similar to, the estate tax schedule. There need not be any accumulation for tax purposes of taxable gifts made during the taxpayer's lifetime; the tax could be based on aggregate gifts at particular times. The present generous exemptions under the gift tax provisions could be reduced.

A more effective integration would be achieved by having one taxing statute under which all gifts would be taxed under one progressive rate

schedule. The tax could be levied on either the donor or the donee, depending on the social purposes intended to be achieved. It would be desirable to have some form of aggregation, either of the gifts made by the donor or of the gifts received by the donee over a period of time 7/. Similarly, the form and extent of exemptions and deductions would be adjusted to achieve the purposes sought. Alternatively, provision might be made for lifetime dollar exemptions which would be used up as gifts were made or received. In addition, there might be a separate exemption for testamentary gifts. There would need to be special averaging provisions for large transfers.

This tax might be implemented by simply adjusting the gift tax rates to equal the estate tax rates, or there might be a more thorough integration, beginning with a harmonization of the exemptions and deductions, and concluding with a complete integration of the two taxes 8/. The following remarks apply, to greater or less degree, to all forms of this tax, depending on the amount of integration desired.

Conformity to Social and Economic Objectives

Such a tax might or might not be imposed in accordance with ability to pay. If the tax was imposed on the donor, the rates would probably be based on the aggregate of gifts made by each donor regardless of their distribution. Such a tax would not be consistent with the principle of taxing in accordance with ability to pay. This would be true, even if the tax was imposed on the donee, if the rate of tax applied was based on the aggregate gifts by the donor.

If the rates were based on the aggregate of gifts received by the donee, the tax would be levied on a basis approaching ability to pay, but not necessarily to the extent provided for in our proposals, under which gifts would be integrated into the comprehensive tax base. Depending on the rate structure, an integrated transfer tax could be used to inhibit the

undue accumulation and concentration of wealth, since all wealth accumulated over a lifetime would eventually be taxed at progressive rates when it passed to others. The system could be designed in such a way that the opportunity to avoid tax would be limited 9/.

If the rates imposed on inter vivos gifts and gifts arising on death were equalized, the timing of gifts would become less important. If the rates depended on the amount given by the donor, there would be no incentive to spread the accumulated wealth widely. That is to say, it would be no more expensive to give or leave all of one's wealth to a single child than to distribute it widely among children or other relatives. However, it is unlikely that an incentive to distribute wealth more widely would be of much practical importance because of the apparent propensities of parents to distribute wealth equally among children.

Fairness of the Tax Base

By taxing inter vivos gifts and testamentary gifts equally, the avoidance of estate tax by means of inter vivos gifts would be prevented and the treatment of gifts would be equalized. Under the present system, the same aggregate amount of gifts made by a donor may bear widely differing amounts of tax, depending upon the timing of the distribution and the taxable income of the donor.

There would be difficulties in maintaining the progressiveness of the tax. If the tax was imposed on the donor, progressiveness could not be maintained by aggregating all forms of income in the donee's hands. There are suggestions that progressiveness could be achieved by aggregating all gifts by a donor, whether inter vivos or otherwise, and applying the progressive rate structure to the aggregate amount of the gifts 10/. There would, however, be administrative difficulties in keeping records of lifetime aggregations of gifts. Such an integrated transfer tax could coexist with the proposed income tax, using a broad base to determine income. Indeed,

a separate transfer tax perhaps would have some additional advantage in that, being a separate and integrated tax on transfers of wealth, it could fully take into account the special problems of valuation and liquidity inherent in taxing transfers of wealth.

Assuming that the justification of exemptions would be their relation to the situation of the donees, it would be difficult to accommodate an integrated transfer tax on donors to a scheme of exemptions such as we have recommended. However, it could be done if the exemption available to the donor was made conditional on the gift actually being made to the donee 11/. The proposed exemptions would be consistent with the purposes of an integrated transfer tax as described above.

An integrated transfer tax would probably be quite acceptable as a logical extension of the present system.

ACCESSIONS TAX

An accessions tax is a cumulative tax on the recipient of gifts and bequests. Such a tax could be graduated according to the total gifts and bequests received in the recipients' lifetime 12/. The tax could be computed readily by applying current rates to aggregate taxable acquisitions to date, including those made in all prior years. From this amount would be deducted the tax computed at current rates on aggregate taxable acquisitions for prior years 13/.

To ease administrative burdens and to allow some exemption to each donee, provision could be made to exempt small gifts. Because all gifts would be aggregated, the impact of the exemption would be the same regardless of the pattern of the gifts.

Conformity to Social and Economic Objectives

An accessions tax could be used both to encourage a wide distribution of wealth and to reduce the rate of accumulation. It would be a feature of

a tax on donees that a donor could reduce total taxes payable by distributing gifts widely to donees with relatively low rates of tax, thus encouraging a wider distribution of wealth. A tax on donees would lead to attempts to defer the tax by the use of trusts or by postponing possession, say, through the imposition of a condition that would have to be satisfied before the gift was complete.

An accessions tax would be more equitable than an integrated transfer tax in that it would come closer to taxing in accordance with ability to pay. Progressiveness could be maintained, to some extent, by various schemes of aggregation. Many countries having integrated transfer taxes limit the aggregation of gifts to a period of time, usually not more than ten years, as it appears that the administrative difficulties of aggregating over a lifetime are substantial. It is also usual for the rates to vary according to the relationship of the donor to the donee. Presumably this type of provision would not be needed if the family unit concept was accepted. Aggregation would meet the problem of dealing fairly with the irregularity of transfers and gifts so as to prevent erosion of the tax base and maintain progressiveness. It would also substantially eliminate opportunities for avoidance.

Fairness of the Tax Base

An accessions tax, like the tax we propose, would be based on the ability of the donee to pay. It would be relatively more closely related to the comprehensive tax base than a separate transfer tax would be, but somewhat less desirable than our proposal from the standpoint of progressiveness, as other forms of income received by the donee would not be taken into account in determining the applicable rate. Deductions and exemptions could be similar to those recommended for gifts under the proposed comprehensive tax base.

SUCCESSION DUTY OR INHERITANCE TAX

A succession duty or inheritance tax is a form of death duty that is imposed on the recipient of a gift. In Canada, succession duties with somewhat differing characteristics are at present levied by three provinces: British Columbia, Ontario and Quebec. The rates of duty imposed by all three statutes vary for three classes of beneficiaries: immediate family, collateral relatives and strangers. Under the present rate structures in Ontario and Quebec, two sets of duties at progressive rates are levied, one depending on the size of the total estate and thus having features of an estate tax, and the other an additional levy depending on the amount received by each beneficiary, in this respect resembling a transfer tax on donees or a true succession duty. Under the Ontario act the additional levy does not apply in the case of gifts to strangers, although they are taxable at the highest initial rate. The British Columbia statute has only one set of rates for each class of beneficiaries and these depend on the size of the total estate. Under all three statutes the tax rate is not concerned with the wealth of the recipient derived from other sources or, indeed, with gifts received from other donors or from the same donor at different times, except gifts made by the donor within three or five years prior to his death.

Canada also imposed a succession duty under the Dominion Succession Duty Act, which was in force from 1941 until it was replaced by the Estate Tax Act, which is applicable in the case of deaths occurring on or after January 1, 1959. Like the Ontario and Quebec statutes, the Dominion Succession Duty Act levied two sets of duties. The initial rate applicable to a gift was determined solely by the size of the total estate, while the additional rate depended both on the amount of the gift and on the relationship of the deceased to the beneficiary, there being four classes of beneficiaries to which different rates applied.

Succession duties and inheritance taxes usually have exemptions and deductions for debts, small bequests and charitable bequests, and substantial

exemptions or deductions for testamentary gifts passing to members of the deceased's family. The differences in treatment of these exemptions under an estate tax and a succession duty are not sufficient to be a factor in the system chosen. The scope of the family exemptions varies according to whether they are intended to compensate for the loss of the provider, in which case they are confined to a wife and dependent children, or whether they are based on blood relationship, in which case the definition of family is broader.

Conformity to Social and Economic Objectives

Like an accessions tax, a succession duty places more emphasis on taxing in accordance with ability to pay than on slowing the rate of the accumulation of wealth. Like the present estate tax, a pure succession duty is subject to avoidance by the use of inter vivos gifts unless it is combined or integrated with a gift tax imposed at comparable rates. It fails to achieve true progressiveness because it does not aggregate successions with other gifts or other forms of income. Hence, a succession duty or inheritance tax is inferior to either an accessions tax or an integrated transfer tax in terms of both maintaining progressiveness and preventing avoidance.

Fairness of the Tax Base

Like the proposed comprehensive tax base and an accessions tax, a succession duty or inheritance tax is based at least to some extent on the ability to pay of the donee. The provision for the inclusion in an estate of gifts made within three or five years of death as is required for the purpose of the federal estate tax and the provincial succession duties is arbitrary and uneven in application, and fails to achieve its purpose of thwarting tax avoidance almost directly in proportion to the wealth and sophistication of the donor. Thus, a pure succession duty is less satisfactory in these respects than either the proposed comprehensive tax base or an accessions tax.

NET WEALTH TAX

A net wealth tax is a tax levied on the net value of a taxpayer's assets at a point of time, including unrealized capital gains. Several countries have such a tax 14/, which is levied annually, usually at a low flat rate of between one half of 1 per cent and 3 per cent. Some European countries, such as Austria, Finland, The Netherlands and West Germany, have both a net wealth tax and death taxes.

In order to reduce administrative problems it is usual to exempt property under certain aggregate amounts. For example, West Germany has exemptions of about $2,500 for single persons, $5,000 for married persons, and $7,500 for old people and invalids. In Sweden, where the property of a husband and wife is aggregated, the exemption is approximately $16,000. Some commentators have suggested an exemption of up to $50,000 which would diminish as wealth increased 15/. Another has taken the view 16/ that, in order to reduce the administrative burden, $200,000 would not be too high an exemption. The proper rate of exemption is a matter of the degree of redistribution of wealth that is desired.

It is also common to exempt certain kinds of property which are for personal use, are of small importance or are relatively hard to value. Most commonly exempted are personal and household effects except jewellery and works of art, life insurance policies and pension rights, and, occasionally, certain types of property of particular importance to the economy of the country, such as livestock in Switzerland and assets used in agriculture in India.

The frequency with which a net wealth tax is imposed is important, particularly in determining an appropriate rate. Such a tax might be levied annually or at longer intervals; if levied only at death it would be similar to an estate tax. Most countries which levy such taxes do so annually.

It should not be assumed that because a number of European countries have a net wealth tax, it could necessarily be successfully introduced in Canada. In the first place, the regular income tax may be less efficient in many countries, so that they rely on a multi-base tax system. Secondly, in many cases the collection of the tax is inequitable. Some assets may continue to be valued at cost without adjustment for increases in market value. Some assets, such as corporate shares and other intangibles, and particularly those held abroad, may escape the tax net. Some types of assets which are difficult to value may be largely ignored, although the valuation problem is often specifically alleviated for assets for which there is no ready market value by requiring valuation only every three to five years. Thus, there are difficulties in imposing and collecting a net wealth tax on an equitable basis.

Conformity to Social and Economic Objectives

A net wealth tax might apply to a wide or narrow base, that is, to the world-wide wealth of a resident of Canada or only to the wealth situate in Canada. Because the situs of securities and other intangible property could easily be arranged to be outside Canada, thereby removing a substantial part of the base, we have given consideration to the more effective alternative of an annual net wealth tax on all the wealth of persons resident in Canada.

A net wealth tax that is imposed at death is essentially an estate tax, which has been considered earlier. An annual net wealth tax would better satisfy the criteria of a broad base and ability to pay. Since much of the wealth is concentrated in relatively few hands, the tax would be hard to avoid because there would be a year-by-year check on assets. However, the problems of valuation and administration emerge as serious difficulties which in practice might limit the effectiveness of the tax. Most net wealth taxes are imposed at flat rates, and so have little effect on the distribution of wealth. Whether or not such a tax would affect the accumulation of wealth would depend on the rates. At the rates usually imposed, it might

slow the rate of accumulation of wealth, but whether it would do so to any greater extent than the present estate tax is difficult to say 17/.

Fairness of the Tax Base

Transfers of wealth, as such, would in general cease to have tax consequences. The new owner of the wealth would pay tax on his increased base.

The major problems, however, of an annual net wealth tax are such that we do not recommend it at this time. The reasons for this view are discussed in Chapter 7 where we point out some of its advantages and disadvantages. It has been criticized as inhibiting growth, but this argument would appear to be inconclusive, considering the experience of European nations which have such taxes and, in some cases, death taxes as well. It is sometimes suggested that the tax might be restricted to certain kinds of assets, such as land and securities, in order to simplify administration. However, if the tax was not comprehensive, it would be neither fair nor neutral. There would, of course, be valuation problems if market values were used, as they should be. These would be unavoidable under any system of wealth tax.

REFERENCES

1/ In contrast, under the United States gift tax, lifetime gifts are aggregated, subject to a generous deduction. Such gifts are not liable to estate tax, except for gifts made in contemplation of death. Gifts made within three years of death are presumed to have been made in contemplation of death, unless the presumption is rebutted. In Estate and Gift Taxation, ed. G. S. A. Wheatcroft, Sweet and Maxwell, 1965, it is suggested at p. 129 that inter vivos gifts should be aggregated with property passing on death for purposes of the estate tax.

2/ See D. B. Fields and E. J. Mockler, Gift Tax, a study published by the Commission, for a detailed discussion of the faults of the present gift tax exemptions.

3/ Sections 3(1)(h) and 4(2).

4/ Section 22(1).

5/ Section 22(2)(a)(i).

6/ The problems which would be solved and those which would remain are considered in Chapter 17. In particular, the adoption of the family unit would remove the need for the exemption of certain once-in-a-lifetime gifts of real property. The provision for inclusion in an estate, for estate tax purposes, of gifts made within three years of death could also be dropped.

7/ For a comparison of the French, German and Swedish gift tax systems, especially the provisions for aggregating gifts of previous years, see the study on gift tax cited above. See also the discussion of an integrated transfer tax in Appendix E to J. G. Smith and E. J. Mockler's Estate Tax, a study published by the Commission.

8/ See Federal Estate and Gift Taxes: A Proposal for Integration and for Correlation with the Income Tax, Washington: United States Government Printing Office, 1947, for a comprehensive study of an integrated transfer tax on the donor, including a draft of a statute to implement the proposal.

9/ When a transfer tax is imposed on the donor, the experience of most taxing jurisdictions is that there are increasingly elaborate attempts to take advantage of relatively low rates of tax on inter vivos gifts. This results in increasingly complex legislation designed to bring into tax property which the donor, by the use of trusts or otherwise, has transferred during his lifetime, but over which he often retains a considerable measure of control.

10/ Section 2502 of the United States Internal Revenue Code requires the aggregation of lifetime gifts in establishing the rate of tax on each successive gift.

11/ Unlike the exemptions for a surviving wife and dependent children under the present Estate Tax Act, which are available whether or not the gifts are actually made to the wife and children.

12/ See C. S. Shoup, Report on Japanese Taxation by the Shoup Mission, General Headquarters Supreme Commander for the Allied Powers, Tokyo, Japan, 1949, for a detailed exposition of an accessions tax. See also the study on gift tax published by the Commission, cited above, for a discussion in detail of the advantages and disadvantages of such a tax.

13/ The gift tax on donors under the United States Internal Revenue Code is computed in a similar way.

14/ Net wealth taxes are levied by Austria, Denmark, Finland, West Germany, Luxembourg, The Netherlands, Norway, Switzerland, Sweden, India and Japan.

15/ R. I. Downing, H. W. Arndt, A. H. Boxer, R. L. Mathews, Taxation in Australia: Agenda for Reform, Melbourne University Press, 1964, p. 111.

16/ G. S. A. Wheatcroft, "The Administrative Problems of a Wealth Tax", [1963] British Tax Review 410, p. 422.

17/ The available data suggest that the European net wealth taxes raise between 1.5 per cent and 2 per cent of total tax revenue, which is similar to our yield from estate and gift taxes.

APPENDIX E

FORMULAE FOR DETERMINING THE TAX ON A TAX-PAID GIFT

Where a gift is made on the basis that the tax is paid by someone other than the donee, it is necessary to compute the tax and also the gross amount of the gift, which is the total of the net gift and the tax on the gross gift. Under the Estate Tax Act the Department of National Revenue has followed an elaborate procedure involving ten successive calculations of tax for this purpose. Although this method was upheld by the Supreme Court of Canada in M.N.R. v. Estate of E.W. Bickle, Mr. Justice Judson stated that "It should be possible to state the Minister's proposition in such a way that an actuarial training is not needed to understand it." 1/ He went on to say that, according to the evidence, the same result might be obtained by the application of an algebraic formula.

In this appendix we set out the appropriate formulae for determining the tax in this situation. The formula is simple where the entire tax on the gift falls within one rate bracket. When the gross amount of the gift is such that the tax thereon falls within two or more rate brackets, the formula must be modified.

Legend

- N - the net gift after federal tax, but including any provincial tax which, it is assumed, will always be constant.
- T(1) - the tax calculated on N.
- T(2) - the tax on the gross gift, that is, on N+T(2).
- k - the part of the tax bracket within which the upper limit of N falls which is in excess of N unless this is the top bracket.
- r - the rate of tax applicable to k, or the rate of tax applicable to the top bracket if the upper limit of N is in the top bracket.
- k' - the amount included in the tax bracket next above k.
- r' - the rate of tax applicable to k'.
- k" - the amount included in the tax bracket next above k'.
- r" - the rate of tax applicable to k".

If the gift, including the tax, or some portion of it is eligible for a provincial tax credit, this must be taken into account in determining r, r' and r". For example, if the rate of tax stated to be applicable to k was 30 per cent while two thirds of the property was located in Quebec (50 per cent credit), one sixth in British Columbia (75 per cent credit) and one sixth in New Brunswick (no credit), r would be 30 per cent minus 50 per cent of two thirds of 30 per cent (10 per cent) and minus 75 per cent of one sixth of 30 per cent (3.75 per cent), or 16.25 per cent.

Formula 1 - where the tax on the gifts falls within one rate bracket.

$$T(2) = \frac{T(1)}{1-r}$$

If the tax on the gift T(2) falls within more than one rate bracket, the application of this formula will usually indicate the number of brackets within which this tax will fall. If it is more than one bracket, it will then be necessary to apply one of the following formulae.

Formula 2 - where the tax on the gift falls within two rate brackets.

$$T(2) = \frac{T(1) + rk - r'k}{1 - r'}$$

Formula 3 - where the tax on the gift falls within three rate brackets.

$$T(2) = \frac{T(1) + rk + r'\,k' - r''\,(k + k')}{1 - r''}$$

If the tax falls within more than three rate brackets, which is unlikely, the formula can be further modified to provide for this case.

REFERENCE

1/ 66 DTC 5179 at p. 5180.

APPENDIX F

ALTERNATIVE METHOD OF TAXING DEFERRED GIFTS

Under the system of taxing deferred gifts that is proposed in Chapter 17, an initial tax would be levied on gifts payable in instalments and on gifts in trust, in order to achieve the important objectives of equality and neutrality in the taxation of all forms of income at a point of time. Although this method of achieving equality would add some complexity to the system, the exclusion from taxation of gifts between spouses in the family unit, which would constitute a large proportion of deferred gifts, would serve to minimize this feature.

Nevertheless, an alternative system of taxing deferred gifts which has the attraction of somewhat greater simplicity can be outlined. Such a system would entail deferring the tax on such gifts until the gift was received in possession by the annuitant, life tenant or beneficiary of a trust. Because the tax would be levied only as and when the amounts were received, this method would also provide a simple way of taxing life interests. If our recommendations regarding the integration of gifts into the comprehensive tax base are not adopted, this alternative method of taxing gifts which are payable in instalments, or the possession of which is deferred, should be given consideration.

The principal feature of such a system is that it would permit deferment of tax with respect to all forms of gift, in contrast to other kinds of income. Thus, a form of preferential tax treatment would be extended to gifts that would not be available to other forms of income. It should perhaps be emphasized that this system could be applied equally under the comprehensive tax base proposed in this Report, under the alternative of an integrated transfer tax referred to in Appendix D to this Volume, or under the present system of estate and gift taxation. It could be applied either to a system which taxed the donor or to a system which taxed the donee.

The treatment of the various forms of gift may be outlined as follows:

1. Direct Gifts. The donee of a direct gift would have the option of taking the gift into income immediately and paying tax at his marginal rate or of depositing the gift in an interest-bearing Income Adjustment Account bearing interest at 5 per cent.

2. Annuities and Life Interests. Annuitants and the beneficiaries of life interests, including widows who were beneficiaries of pensions under a provision for a joint life pension with continued payments to the survivor, would pay tax on the full amount of payments received as and when received, assuming that our recommendations with respect to tax-free transfers within the family unit were not accepted. If the annuitant or life tenant died prematurely, there would be no liability for tax in respect of payments which were not ultimately received, as may be the case under the present Estate Tax Act, which contains only limited provisions for adjusting the tax in case of premature death of an annuitant.

   Assuming that the family unit proposals were adopted, if a gift was made to a spouse or other member of a family unit, the part of the payments attributable to the original fund would be exempt and only the interest element would be taxed as and when received.

3. Pension and Retirement Savings Payments. Payments out of Registered Retirement Income Plans would be fully taxable no matter to whom they were payable. This would be so because the fund from which the payments were made would have been created from tax-free contributions, so that all payments should be taxed whether paid to the employee, his spouse or other beneficiaries. This is similar to the treatment which is proposed in Chapter 16. As explained in that chapter, the deferment of income tax at the time of contribution is justified on broad social grounds.

4. Remainder Interests. Remainder interests would be taxed in full when they were received at their then value, which would include any gain in value between the time when the property was placed in trust and the time when it came into the possession of the remainderman. There would be no need to distinguish between vested and contingent remainders, as tax would be imposed only when the property came into possession. This would simplify considerably the taxation of complex trust interests, although it would still be necessary to provide for the taxation of income other than a gift when it was received by a trust.

5. Powers of Appointment and Powers of Encroachment. Persons benefiting from the exercise of powers of appointment and powers of encroachment would pay tax at their personal rates on the property when received. There would be no need to tax the holders of general powers of appointment or encroachment.

The foregoing is a brief outline of an alternative system of taxing gifts. It would achieve some simplicity at the cost of giving all gifts a deferment of tax in comparison with other forms of income, which would be taxed when received or, in some cases, when accrued.

APPENDIX G

A SUMMARY OF THE UNITED KINGDOM ESTATE TAX AND THE UNITED STATES GIFT TAX AND ESTATE TAX

We are outlining only the United Kingdom and the United States methods of taxing transfers of wealth because the general tax environment of these countries is relatively similar to that of Canada. Summaries of other methods of taxing transfers of wealth can be found in the study on gift tax published by the Commission 1/.

UNITED KINGDOM

The United Kingdom levies an estate duty under the provisions of the Finance Act of 1894, as amended, but does not levy any tax on inter vivos gifts, except that those made within five years of the death of the donor are subject to estate duty. In general, the estate duty applies to property situate in the United Kingdom passing on the death of a deceased. Property situate outside the United Kingdom is also taxed unless the law applying to the devolution is neither English nor Scottish, and either (a) the deceased died domiciled outside the United Kingdom, or (b) the property passed under a disposition made by a person who was domiciled outside the United Kingdom when he made it.

Estate duty is levied on "property passing on the death" of a deceased. The definition of such property is quite complex, and includes items which are generally similar to the types of property included under section 3 of the Canadian Estate Tax Act, for example, property that the deceased owned or was competent to dispose of, gifts made within five years of death, gifts with a reservation of benefit, benefits from insurance policies provided by the deceased, and the beneficial interest in joint annuities arising on death.

One property interest that is taxed in the United Kingdom but is not taxed in Canada is the value of a life interest which has terminated 2/. Under the United Kingdom law, when a life interest created under a will has

terminated there is a second tax on the property interest passing because of the termination, the first tax having been paid, of course, on the death of the testator. The same position obtains where the life interest is created under an inter vivos settlement and the settlor fails to live for five years after the settlement 3/. Because this duty was being avoided by life tenants selling their interests to remaindermen, or by remaindermen releasing or selling their interests to life tenants, provisions were introduced to include in the estate of a person who transferred such an interest the value of the interest transferred, unless the transfer was made more than five years prior to death.

Deductions from the estate include expenses (but not the costs of administration or losses incurred during administration), debts and gifts made for public or charitable purposes. There are various other exemptions of considerable importance, such as an exemption for estates not exceeding £5,000. Of particular interest, in view of our recommendations relating to the family unit, is a provision that where the surviving spouse has only a limited interest in settled property, the estate is exempt on the death of that spouse. There are also special reliefs or credits against the duty which reduce the rate. The rate of duty on the agricultural value of agricultural land and on industrial plant and machinery used for the purposes of a business is reduced by 45 per cent. Some property in which the deceased did not have an interest is dutiable but is not aggregated with the rest of his assets for estate duty, duty being levied on that property separately.

There is a graduated reduced rate for quick successions and a tax credit for foreign taxes paid on property situate in a foreign country. Unilateral relief given by the statute to relieve double taxation is superseded when the United Kingdom has a reciprocal convention with another country such as Canada or the United States.

Valuation is generally at market value, with special rules applying in particular to shares of controlled companies. Duty is levied on a graduated scale from 1 per cent where the principal value is from £5,000 to £6,000, to 8 per cent where the value is over £1,000,000. The rate in each bracket applies to the whole estate and is therefore also the average rate and not the marginal rate on the excess over the previous bracket, as under the Canadian estate tax.

Generally, tax is due six months from death and is payable by the person who owns the property. Thus, if the donor of property dies within five years after making a gift, the donee is liable for the tax. If there is a tax on a trust on the termination of a life interest, the trustees pay the tax. Tax which applies to property owned by the deceased at the date of death, or which he could have owned, say, by exercising a power of appointment, is payable by the personal representatives of the deceased.

UNITED STATES

The United States federal government levies both an estate tax and a gift tax under the Internal Revenue Code and Regulations 4/. The taxes apply to all citizens and residents in respect of property subject to tax, whether the property is situate inside or outside the United States. The jurisdiction assumed over non-resident aliens is more complex. Estate tax is levied on all taxable property situate in the United States. Gift tax applies to all such property if the non-resident alien is carrying on business in the United States, but only to real and tangible personal property situated in the United States if he is not 5/.

Gift Tax

Gifts, though not specifically defined, include all *inter vivos* gratuitous transfers, direct or indirect, and also transfers made for inadequate consideration. Arm's length transactions for business purposes are not included. The rates are progressive by brackets, and vary from

2.25 per cent on taxable gifts up to $5,000 to 57.75 per cent on taxable gifts over $10,000,000. The gift tax rates, after taking all matters into account, are established at a level equal to 75 per cent of the estate tax rates on equal stated bracket amounts. Unlike the position with respect to estate tax, the gift tax liability itself does not form part of a taxable gift.

In determining taxable gifts, there is an annual exclusion of gifts of a present interest of up to $3,000 a year for each donee, in addition to a lifetime exemption of $30,000 for each donor and an unlimited deduction for charitable gifts.

Generally speaking, property is valued at fair market value at the date of the gift, and liability for the tax is on the donor, the donee being liable if the tax is not paid by the donor.

Two features of the tax are noteworthy in the light of our proposed treatment of gifts and inheritances. In mitigation of the tax, a gift by a married person to any person other than his spouse may, by election applicable to all gifts made in the year, be considered to have been made one half by each spouse. In addition, there is a marital deduction to the extent of 50 per cent of gifts by one spouse to the other. On the other hand, all previous taxable gifts made by a donor must be aggregated in computing the rate of tax. The procedure is quite simple: tax is calculated at current rates, first, on the aggregate of all taxable gifts made by a donor in preceding years and, second, on the aggregate of all taxable gifts in the current year and preceding years; the difference between the first and the second calculation is the gift tax for the current year.

Estate Tax

The federal estate tax is levied at progressive rates on taxable estates at rates from 3 per cent on taxable estates not over $5,000 to 77 per cent on amounts in excess of $10,000,000. The gross estate includes all

property owned beneficially by the deceased plus a wide variety of types of property in which the deceased had an interest. The property included is generally similar to the property brought into tax by section 3 of the Canadian Estate Tax Act. The gross estate is subject to deductions for administration expenses, casualty losses during administration, debts and charitable deductions. There is also a most important marital deduction which, in effect, allows a spouse to pass one half of his adjusted gross estate 6/ to his surviving spouse tax free, but only if the transfer is outright or in trust with a general power of appointment in the surviving spouse so as to render it subject to estate tax on her death.

There is also a system of tax credits for state death duties of all kinds and for gift tax paid on amounts brought into the gross estate 7/. A foreign tax credit is given by the Code or by tax treaties, and is generally limited to the United States federal tax applicable to the property situate in a foreign country. There is a diminishing credit for tax on prior transfers which is intended to avoid double taxation in the case of two deaths occurring within a comparatively short time.

Valuation is at fair market value, securities listed on exchanges being valued at prices on the exchange, subject to recognition of the problem of disposing of large blocks of stock without depressing the price. Valuation is made as of the date of death of the deceased unless the alternate date of one year from death is elected.

Most of the states also levy death duties of one kind or another.

REFERENCES

1/ D.B. Fields and E.J. Mockler, Gift Tax.

2/ As is explained in Chapter 21, a life interest is created when a donor directs his trustees to pay the income or a fixed amount from a fund to a designated beneficiary for his lifetime. The trust or will usually provides for the disposition of the fund on the death of the life tenant.

3/ It is to be observed that where a trust is entirely discretionary, that is, where an absolute discretion is given to trustees as to the application of the income and capital of the trust fund, estate tax is not charged until the trust finally ends, which could well be several decades after its creation. This loophole has been extensively used for many years.

4/ Estate tax under Subtitle B, Chapter 11, sections 2001 to 2209, and gift tax under Subtitle B, Chapter 12, sections 2501 to 2504.

5/ H.R. 13103, recently passed by the House of Representatives, would eliminate from gift tax transfers of intangible property with a United States situs by any non-resident alien.

6/ The gross estate less deductions for administration expenses, losses and debts is the adjusted gross estate. See section 2056 of the Internal Revenue Code.

7/ The United States rule on the inclusion in the estate of a deceased of transfers of property made before death, other than bona fide sales for full consideration, is more complex than the Canadian rule. Under the United States rule, transfers made within three years of death are deemed to have been made in contemplation of death, subject to rebuttal, and are includible. Transfers made more than three years before death are not considered to have been made in contemplation of death.

APPENDIX H

COMPARISON OF INCOME TAXES PAYABLE AT DIFFERENT INCOME LEVELS IN CANADA AND THE UNITED STATES

This appendix provides more detailed data on income taxes paid at different income levels in Canada and the United States than is provided in the text of Chapter 11, and in doing so makes clear the assumptions used in these comparisons. The important assumptions are the following:

1. In all of these comparisons, the income of a taxpayer is made up entirely of wages and salaries.

2. Any transfer payments received by a taxpayer are excluded from the comparison 1/.

3. No attempt is made to allow for provisions which affect taxes only in subsequent years 2/.

Other assumptions are referred to in notes to the various tables.

The most important single factor resulting in lower income taxes in the United States for middle income families is the much more liberal allowance of deductions from income. Table H-1 shows the total income taxes which would be paid in Canada and the United States by a family that had two children, owned its own home and had an income of $12,000 earned by the head of the household. The second column of Table H-1 shows what tax would be paid by this family if Canadian tax rates were applied to a tax base defined in accordance with United States tax law. As can be seen by comparing this tax with the taxes calculated in the other three columns, the much lower taxes in the United States arise only in part from a lower overall rate schedule. Including average state income taxes, the United States middle income taxpayer pays roughly 10 per cent less tax than does a Canadian taxpayer with the same amount of taxable income 3/. However, because taxable income is, on the average, a lower fraction of gross income

for the United States taxpayer, the middle income United States taxpayer in fact pays almost 30 per cent less tax.

The lower United States taxes result largely from a lower ratio of taxable income to gross income. This lower ratio, in turn, results from the deductibility of items such as mortgage interest, property taxes, state and local sales taxes and state income taxes, as well as from a more liberal definition of what can be claimed as charitable donations, expenses of earning employment income and other deductions.

In the comparisons which follow, taxpayers are compared in three situations:

1. The taxpayer is assumed to be the head of a family with a wife and two children and to claim itemized deductions equal to the average deductions claimed by taxpayers who itemize.

2. The taxpayer is assumed to be single, to have no dependants and to claim only the standard deductions 4/.

3. The taxpayer is assumed to be married, to have no children and to claim only the standard deductions.

Data on estimated average itemized deductions are presented in Tables H-3 and H-4; tax comparisons are presented in Tables H-5, H-6 and H-7.

Some previous comparisons of United States and Canadian income taxes have been made using income taxes paid by residents of New York State as representative of state and local income tax payments in the United States 5/. As Table H-2 shows, income taxes in New York State are actually higher than in any other major state except Wisconsin. In fact, they are roughly 2.7 times as high as average state and local income taxes combined in the United States. All comparisons reported in Tables H-5, H-6 and H-7 are consequently based on the average state and local income taxes deducted by all taxpayers filing returns with itemized deductions. Since it may be of

interest, average income taxes paid by a resident of New York State with a wife and two children and with deductions itemized are shown in Table H-8. As can be seen by comparing this table with Table H-5, income taxes are lower than Canadian income taxes, even for taxpayers in New York State.

It should be emphasized that the comparisons in this appendix and in Chapter 11 include personal income taxes only. The United States capital gains tax is not taken into account and it is assumed that gross income is defined in the same way in the two countries. No attempt has been made to take into account other direct taxes, such as corporate income taxes or gift taxes, which reduce the net economic power of a taxpayer. Compulsory payments into government pension plans have also been excluded. Because compulsory payments into government pension schemes have been included in an earlier comparison, 6/ a comparison including Social Security taxes for United States taxpayers and Canada Pension Plan payments for Canadian taxpayers is presented in Table H-9. As can be seen by comparing the figures in Table H-9 with those in Tables H-5 and H-6, the inclusion of these compulsory government pension plan contributions does not materially affect the range of incomes for which taxes are lower in the United States. In spite of the recent large increase in Social Security taxes in the United States to pay for a restricted medicare programme, income taxes and compulsory social security contributions are still less in the United States than in Canada for taxpayers with incomes over $8,000 who have two children and itemize deductions.

TABLE H-1

COMPARISON OF INCOME TAXES WHICH WOULD BE PAYABLE UNDER CANADIAN AND UNITED STATES TAX LAWS BY A HOME-OWNING HUSBAND AND WIFE WITH 2 CHILDREN AND INCOME OF $12,000

	Canadian Tax Calculation Using 1966 Rates		United States Tax Calculation Using 1966 Canadian Rates		United States Tax Calculation Using 1966 United States Rates and 1965 New York State Rates		United States Tax Calculation Using 1966 United States Rates and Average 1962 State Income Tax for All States	
	Dollars							
Income		12,000		12,000		12,000		12,000
Deductions:								
Personal exemptions	2,600		2,400		2,400		2,400	
Medical expenses	136		211		211		211	
Contributions to charities	328		358		358		358	
Retirement savings premiums and pension contributions	335		-		-		-	
Canada Pension Plan contributions	79							
Mortgage interest	-		975		975		975	
Property taxes	-		700		700		700	
Provincial or state sales tax	-		198		198		198	
Provincial or state income tax	-	3,478	324	5,166	245	5,087	123	4,965
Taxable Income		8,522		6,834		6,913		7,035
Federal income tax		1,293		943		1,173		1,196
Old Age Security tax		120		120		-		-
Provincial income tax		414		324		-		-
State income tax		-		-		245		123
Total Income Taxes		1,827		1,387		1,418		1,319

Notes:

1. Personal exemptions are assumed to be two $1,000 exemptions and two $300 exemptions for the Canadian calculation; and four $600 exemptions for the United States calculations, which assume joint returns to have been filed.

2. For the Canadian calculation, medical expenses and contributions to charities are assumed to be the average for all Canadian taxpayers with incomes between $10,000 and $15,000 in 1964 with itemized deductions; retirement savings premiums and pension contributions are assumed to be equal to the average for all taxpayers in that income class. These average figures were multiplied by the ratio of $12,000 to mean income in the class to make them consistent with an income of $12,000. The data were obtained from Table 2 of 1966 Taxation Statistics: Individual Tax Statistics for 1964, Ottawa; Department of National Revenue, preliminary figures. For the United States calculations, medical expenses and contributions to charities were estimated in the same way from data in Tables 13 and 14 of the Statistics of Income 1962: Individual Income Tax Returns, Washington; Internal Revenue Service, 1965.

3. Mortgage interest and property taxes are assumed to correspond to what would be paid by the family if it owned a $25,000 home with a $6\frac{1}{2}$ per cent mortgage of $15,000 outstanding, and if property taxes were assessed at 70 mills on an assessment equal to 40 per cent of market value.

4. Provincial sales taxes are assumed to be the amount deductible without documentation as given by the optional state sales tax tables provided in the United States federal income tax form (Form 1040 for 1965) for a state with a 5 per cent retail sales tax.

5 For the calculations according to United States procedures, but using 1966 Canadian rates, provincial income tax is computed as 24 per cent of the "basic" federal income tax on taxable income before deducting provincial income tax. "Basic" federal tax is the federal income tax before deduction of the 24 per cent provincial tax abatement and of the $20 tax decrease introduced in 1966.

6 New York State income taxes were calculated using 1965 New York State rates on taxable income as defined for federal income tax purposes, less New York State tax. Average 1962 state income taxes were estimated as in Table H-2.

TABLE H-2

AVERAGE STATE AND LOCAL INCOME TAXES DEDUCTED ON UNITED STATES FEDERAL INCOME TAX RETURNS WITH ITEMIZED DEDUCTIONS IN 1962, BY STATES WITH MORE THAN 1,000,000 TAX RETURNS

States	Number of Tax Returns	Number of Tax Returns With Itemized Deductions	Average State Income Tax Deducted
Wisconsin	1,407,472	493,951	$ 278.2
New York	6,629,260	3,524,191	232.8
Minnesota	1,191,577	513,152	170.6
Massachusetts	2,029,442	865,839	142.7
North Carolina	1,353,694	571,113	142.4
Maryland (inc. D.C.)	1,619,915	593,313	139.9
Virginia	1,320,568	462,375	129.9
Indiana	1,590,890	438,991	97.1
All United States Returns	62,709,083	26,455,432	85.4
Georgia	1,096,984	433,546	84.1
California	6,186,519	3,298,793	77.4
Missouri	1,483,258	611,231	69.8
New Jersey	2,386,667	1,147,262	29.1
Connecticut	1,007,534	398,117	27.0
Tennessee	1,090,583	427,577	14.8
Pennsylvania	4,021,286	1,645,179	12.4
Washington	1,018,194	426,865	7.3
Florida	1,685,127	835,994	5.6
Ohio	3,360,412	1,303,862	5.2
Michigan	2,612,414	1,197,409	5.2
Illinois	3,806,569	1,461,373	4.5
Texas	3,020,013	1,072,486	3.4

Source: Statistics of Income, 1962: Individual Income Tax Returns, Washington; Internal Revenue Service, 1965, Tables 26, 28 and 29.

TABLE H-3

AVERAGE ITEMIZED DEDUCTIONS IN THE UNITED STATES AT DIFFERENT INCOME LEVELS FOR MARRIED TAXPAYERS FILING JOINT RETURNS IN 1962

Income	Medical Expenses	Charitable Contributions	State and Local Income Taxes	Other State and Local Taxes	Interest	Other Deductions	Total Deductions
$ 1,500	-	-	$ 3	-	-	-	-
2,500	$ 169	$ 88	23	$ 112	$ 70	$ 55	$ 517
3,500	222	143	39	183	152	97	836
5,000	193	180	56	268	290	133	1,120
6,500	232	218	68	322	350	161	1,351
8,000	191	248	86	409	453	165	1,552
10,000	184	312	106	510	519	191	1,822
12,000	211	358	123	584	597	220	2,093
15,000	248	483	154	736	595	285	2,501
25,000	314	842	247	1,176	757	490	3,826
40,000	493	1,323	388	1,850	1,191	770	6,015
70,000	677	2,954	676	3,233	1,944	1,622	11,106
100,000	711	6,083	912	4,352	3,006	2,721	17,785
200,000	562	19,854	1,640	7,826	5,334	4,893	40,109
350,000	1,031	36,450	3,010	14,368	9,794	8,983	73,636
600,000	1,783	63,040	5,206	24,849	16,938	15,537	127,353

Note: The deductions presented in this table were estimated from separate estimates of average total deductions associated with each income level and of the average percentage breakdown of total deductions. Total deductions were interpolated from data in Table 13 on average total deductions by income class for joint returns of husbands and wives with itemized deductions, assuming each average deduction to correspond to total deductions claimed by a taxpayer with income equal to the average adjusted gross income of taxpayers in the class. The percentage breakdown of total deductions was likewise interpolated from data in Table 14 on total deductions of each type claimed in each income class by all returns with itemized deductions. State and local income taxes were assumed to be a constant 17.3 per cent of total state and local taxes deducted, based on average United States data in Table 29.

Source: Statistics of Income, 1962: Individual Income Tax Returns, Washington; Internal Revenue Service, 1965, Tables 13, 14, and 29.

TABLE H-4

AVERAGE ITEMIZED DEDUCTIONS AT DIFFERENT INCOME LEVELS FOR CANADIAN TAXPAYERS IN 1964 ADJUSTED FOR CANADA PENSION PLAN CONTRIBUTIONS

Income	Pension Contri-butions	Retirement Savings Plan Premiums	Medical Expenses	Chari-table Contri-butions	Canada Pension Plan	Total Deduc-tions
$ 1,500	6	-	83	97	16	202
2,500	19	-	90	140	34	283
3,500	50	1	101	166	52	370
5,000	107	3	121	178	79	488
6,500	152	7	126	191	79	555
8,000	190	12	142	271	79	694
10,000	228	44	131	280	79	762
12,000	270	66	135	328	79	878
15,000	301	153	143	370	79	1,046
25,000	341	386	160	683	79	1,649
40,000	402	594	189	1,145	79	2,409
70,000	483	628	255	2,302	79	3,747
100,000	496	523	306	3,841	79	5,245
200,000	536	632	449	9,984	79	11,680
350,000	608	1,086	652	19,727	79	22,152
600,000	1,043	1,862	1,117	33,817	79	37,918

Note: Deductions presented in this table were interpolated as in Table H-3 from estimates of average deductions of each type for taxpayers classified by income class. Average pension contributions and retirement savings plan premiums were estimated for all taxpayers in an income class; medical expenses and contributions to charities were averaged over taxpayers not claiming the standard deduction (equal to the total amount claimed as standard deductions divided by 100). Although the Canada Pension Plan did not exist in 1964, the table gives the amounts which would have been payable by taxpayers receiving their income in the form of wages and salaries if the Plan had been in force in 1964.

Source: <u>1966 Taxation Statistics: Individual Tax Statistics for 1964</u>, Ottawa; Department of National Revenue, preliminary figures Table 2.

TABLE H-5

INCOME TAXES PAYABLE IN THE UNITED STATES AND CANADA BY A MARRIED TAXPAYER WITH A WIFE AND 2 CHILDREN FILING AVERAGE ITEMIZED DEDUCTIONS AT DIFFERENT INCOME LEVELS (1966 RATES)

	United States Income Taxes				Canadian Income Taxes			
Income	Taxable Income	Federal Income Tax	State and Local Income Tax	Total	Taxable Income	Income Tax	Old Age Security Tax	Total
$ 1,500	-	-	3	3	-	-	-	-
2,500	-	-	23	23	-	-	-	-
3,500	264	37	39	76	530	46	21	67
5,000	1,480	292	56	348	1,912	218	76	294
6,500	2,749	410	68	478	3,345	466	120	586
8,000	4,048	629	86	715	4,706	745	120	865
10,000	5,778	958	107	1,065	6,638	1,196	120	1,316
12,000	7,507	1,286	123	1,409	8,522	1,707	120	1,827
15,000	10,099	1,842	154	1,996	11,354	2,624	120	2,744
25,000	18,774	4,037	247	4,284	20,751	6,638	120	6,758
40,000	31,585	8,498	388	8,886	34,991	13,546	120	13,666
70,000	56,494	20,441	676	21,117	63,653	29,242	120	29,362
100,000	79,815	33,233	912	34,145	92,155	46,451	120	46,571
200,000	157,491	81,924	1,640	83,564	185,720	110,304	120	100,424
350,000	273,964	162,755	3,010	165,765	325,248	212,986	120	213,106
600,000	470,247	300,153	5,206	305,359	559,482	396,635	120	396,755

Note: For both countries, taxable income was calculated by subtracting from income the sum of allowable personal exemptions ($2,400 in the United States and $2,600 in Canada) and total itemized deductions presented in Tables H-3 and H-4. All taxes except United States state and local taxes were calculated at 1966 rates. United States state and local taxes were assumed to be the 1962 averages presented in Table H-2. For the United States calculations, it was assumed that joint returns were filed. Canadian income tax is the federal income tax before deduction of the provincial abatement.

TABLE H-6

INCOME TAXES PAYABLE IN THE UNITED STATES AND CANADA BY SINGLE TAXPAYERS WITH NO DEPENDANTS CLAIMING STANDARD DEDUCTIONS ONLY
(1966 RATES)

	United States Income Taxes				Canadian Income Taxes			
Income	Taxable Income	Federal Income Tax	State and Local Income Tax	Total	Taxable Income	Income Tax	Old Age Security Tax	Total
$ 1,500	600	87	3	90	400	35	16	51
2,500	1,600	244	23	267	1,400	142	56	198
3,500	2,600	419	39	458	2,400	298	96	394
5,000	3,900	671	56	727	3,900	571	120	691
6,500	5,250	965	68	1,033	5,400	898	120	1,018
8,000	6,600	1,280	86	1,366	6,900	1,264	120	1,384
10,000	3,400	1,742	107	1,849	8,900	1,820	120	1,940
12,000	10,400	2,318	123	2,441	10,900	2,465	120	2,585
15,000	13,400	3,334	154	3,488	13,900	3,610	120	3,730
25,000	23,400	7,730	247	7,977	23,900	8,055	120	8,175
40,000	38,400	15,942	388	16,330	38,900	15,500	120	15,620
70,000	68,400	34,166	676	34,842	68,900	32,390	120	32,510
100,000	98,400	54,386	912	55,298	98,900	50,835	120	50,955
200,000	198,400	124,370	1,640	126,010	198,900	119,530	120	119,650
350,000	348,400	229,370	3,010	232,380	348,900	230,725	120	230,845
600,000	598,400	404,370	5,206	409,576	598,900	428,170	120	428,290

Note: The same assumptions were used as in Table H-5, except that joint returns were not assumed to have been filed and that standard statutory deductions were used rather than itemized deductions.

TABLE H-7

INCOME TAXES PAYABLE IN THE UNITED STATES AND CANADA BY MARRIED TAXPAYERS WITH NO DEPENDENT CHILDREN, CLAIMING STANDARD DEDUCTIONS ONLY (1966 RATES)

	United States Income Taxes				Canadian Income Taxes			
Income	Taxable Income	Federal Income Tax	State and Local Income Tax	Total	Taxable Income	Income Tax	Old Age Security Tax	Total
$ 1,500	-	-	3	3	-	-	-	-
2,500	1,100	155	23	178	400	35	16	51
3,500	1,900	275	39	314	1,400	146	56	202
5,000	3,300	501	56	557	2,900	383	116	499
6,500	4,650	744	68	812	4,400	678	120	798
8,000	6,000	1,000	86	1,086	5,900	1,008	120	1,128
10,000	7,800	1,342	107	1,449	7,900	1,524	120	1,644
12,000	9,800	1,776	123	1,899	9,900	2,120	120	2,240
15,000	12,800	2,460	154	2,614	12,900	3,210	120	3,330
25,000	22,800	5,276	247	5,523	22,900	7,605	120	7,725
40,000	37,800	11,150	388	11,538	37,900	15,000	120	15,120
70,000	67,800	26,510	676	27,186	67,900	31,790	120	31,910
100,000	97,800	43,860	912	44,772	97,900	50,185	120	50,305
200,000	197,800	109,462	1,640	111,102	197,900	118,830	120	118,950
350,000	347,800	214,440	3,010	217,450	347,900	229,975	120	230,095
600,000	597,800	389,440	5,206	394,646	597,000	427,370	120	427,490

Note: The same assumptions were used as in Table H-5, except that standard statutory deductions were used rather than itemized deductions.

TABLE H-8

INCOME TAXES PAYABLE IN NEW YORK STATE BY A HUSBAND AND WIFE WITH 2 DEPENDENT CHILDREN CLAIMING ITEMIZED DEDUCTIONS

Income	New York State Taxable Income	New York State Income Tax	Taxable Income for Federal Tax	Federal Income Tax	Total Income Taxes
$ 1,500	-	-	-	-	-
2,500	-	-	-	-	-
3,500	303	-	303	42	42
5,000	1,536	11	1,525	219	230
6,500	2,817	50	2,767	413	463
8,000	4,134	100	4,034	621	721
10,000	5,885	179	5,706	944	1,123
12,000	7,630	273	7,357	1,256	1,529
15,000	10,253	443	9,810	1,778	2,221
25,000	19,021	1,237	17,784	3,760	4,997
40,000	31,973	2,532	29,441	7,662	10,194
70,000	57,170	5,052	52,118	18,123	23,175
100,000	80,727	7,408	73,319	29,545	36,953
200,000	159,131	15,248	143,883	72,943	88,191
350,000	276,974	27,032	249,942	145,939	172,971
600,000	475,453	46,880	428,573	270,981	317,861

Note: Taxable income for New York State income tax was estimated by subtracting from income the sum of allowable personal exemptions ($2,600) and average total itemized deductions less average state and local income taxes, presented in Table H-2. New York State income tax was calculated using 1965 rates and credits. Federal income tax was calculated using 1966 rates.

TABLE H-9

TOTAL INCOME AND SOCIAL SECURITY TAXES PAYABLE IN THE UNITED STATES AND TOTAL INCOME TAX AND CANADA PENSION PLAN CONTRIBUTIONS PAYABLE IN CANADA (1966 RATES)

	Single Individual, Claiming Standard Deductions Only		Married Taxpayer With Two Children Claiming Itemized Deductions	
Income	United States	Canada	United States	Canada
$ 1,500	153	67	66	16
2,500	372	232	128	34
3,500	605	446	223	119
5,000	937	770	558	373
6,500	1,306	1,097	751	665
8,000	1,643	1,463	992	944
10,000	2,126	2,019	1,342	1,395
12,000	2,718	2,664	1,686	1,906
15,000	3,765	3,809	2,273	2,823
25,000	8,254	8,254	4,561	6,837
40,000	16,607	15,699	9,163	13,745
70,000	35,119	32,589	21,394	29,441
100,000	55,575	51,034	34,422	46,650
200,000	126,287	119,729	83,841	110,503
350,000	232,657	230,924	165,765	213,106
600,000	409,853	428,369	305,359	396,755

Note: Income is assumed to be composed entirely of wages and salaries in computing Canada Pension Plan payments and United States Social Security taxes. United States calculations include average state and local taxes. Canadian income tax is the federal income tax before deduction of the provincial abatement. All amounts except United States state and local taxes were calculated at 1966 rates. United States state and local taxes were assumed to be the 1962 averages presented in Table H-2. Canada Pension Plan contributions are deductible in computing income, but United States Social Security taxes are not.

REFERENCES

1/ This assumption results in the exclusion of family allowances in the comparisons of taxes paid by families with children. If family allowances were included, it would be necessary to take other transfer payments into account as well in order to be consistent.

2/ This assumption results in giving no weight to the fact that, in the United States, pensions based on a taxpayer's pension contributions will subsequently be received free of tax. At the same time the Canadian allowance of the deduction of pension contributions is not discounted by reason of the fact that the pensions based thereon will later be taxable.

3/ For example, on taxable income of $8,522, the United States taxpayer in an average state would pay state and federal income taxes totalling $1,634; this is $193 less than a Canadian taxpayer living in a province other than Manitoba, Saskatchewan or Quebec would pay.

4/ In Canada, the standard deduction is a flat $100 per taxpayer in lieu of itemized deductions for charitable donations and allowable medical expenses. In the United States, the standard deduction is the greater of: (a) 10 per cent of income; or (b) $100 plus an additional $100 for each dependant claimed; with a maximum standard deduction of $1,000. The United States standard deduction is in lieu of the broader range of itemized deductions, including home owner deductions and state income and sales tax deductions, allowed in that country.

5/ An example is provided by the 1965-66 Budget Speech reported in House of Commons Debates, April 26, 1965. The comparisons made in the Budget Speech differ from the comparisons made in this appendix in that the former are based on an estimate of deductions which is substantially below the United States average and, in the case of a taxpayer with $15,000 income, is actually lower than what can be claimed as a standard deduction.

6/ Budget Speech, House of Commons Debates, April 26, 1965.

APPENDIX I

COMPARISON OF TAX LIABILITIES FOR WAGE EARNERS IN DIFFERENT FAMILY SITUATIONS UNDER THE CURRENT AND PROPOSED TAX SYSTEMS

The tables in this appendix give a detailed comparison of the tax liabilities of different families earning income from employment under the current tax system and the proposed tax system in four cases reflecting different family situations.

These cases are as follows:

1. An unattached individual or a family unit with one income recipient.
2. A family unit with 20 per cent of its income earned by a working wife and the balance by the husband.
3. A family unit with 35 per cent of its income earned by a working wife and the balance by the husband.
4. A family unit in which the husband and wife each earn 50 per cent of the income.

In all cases, it is assumed that all of the income is from employment and that the children are qualified for family allowances, each at the rate of $72 a year.

For each case, three tables are presented. The first table lists the total federal income taxes, before the deduction of the provincial tax abatements, that are payable by unattached individuals and by family units composed of married couples with different numbers of children, given different levels of employment income. The second table shows the effective average tax rate for taxpayers in each situation. The effective average tax rate is the ratio of taxes paid to income. The third table presents estimates of the effective marginal rates applicable to taxpayers in each situation. These estimates are based on the assumption that, currently, tax is imposed on the same proportion of the additional income as of the taxpayer's

entire income. The marginal rates are computed as the effective rate of tax on an additional $500 of income.

The four cases analyzed in this fashion show the effect of different proportions of income being earned by husbands and wives. In the last three cases, it is assumed that families with dependent children are eligible for the $80 working mother credit but not for the additional $120 credit for families with children younger than seven, although it is unlikely that families with many children would not be eligible for the latter credit.

In all these tables, in calculating tax liabilities under the proposed system, income is determined under the comprehensive definition, and is assumed, for illustrative purposes, to be employment income only, apart from family allowances, which are also taken into account. It is assumed that the $50 standard deduction and the 3 per cent optional standard employment expense deduction are claimed and that no additional allowable deductions are itemized. Alternatively, it may be assumed that any additional deductions beyond these amounts are offset by the attribution of fringe benefits and other components of the comprehensive tax base which at present are untaxed. Current tax includes both income tax and old age security tax. Parents of dependent children are assumed to be receiving family allowances of $6 per month per child.

The way in which the taxes are computed under the first table for each case can best be described by reference to several examples. Example 1 (a single individual earning $3,500) shows the method of calculation of the two tax figures which are presented in the fifth set of three figures in the column headed "unattached individual" in Table I, 1-1. Gross taxes under our proposals are calculated using the rate schedule for individuals presented in Table 11-4 of Chapter 11. Example 2 (a family with a wife and three children with one income recipient earning $6,500) gives the calculations underlying the two tax figures shown in the eighth set of numbers in the fifth column of Table I, 1-1. Gross taxes in this example

are calculated using the family rate schedule presented in Table 11-6 of Chapter 11. Example 3 (a family with two school-age children in which both spouses work, the husband earning $5,200 and the wife $2,800) gives the calculations underlying the two tax figures shown in the ninth set of figures, that is, the row corresponding to total family income of $8,000, in the third column of Table I, 3-1.

CALCULATION OF TAXES UNDER THE CURRENT AND PROPOSED SYSTEMS
EXAMPLE 1: SINGLE INDIVIDUAL
EARNING $3,500

	Current Tax Calculation	Tax Calculation Under the Proposed System
1. Income Received		
Income earned from employment	$3,500	$3,500
Family allowances	N.A.	0
	$3,500	$3,500
2. Deductions		
Employment expense deduction	N.A.	$ 105
Personal exemption	$1,000	N.A.
Dependant allowances	0	N.A.
Standard deduction	100	50
	$1,100	$ 155
3. Net Taxable Income	$2,400	$3,345
4. Gross Tax		
Income tax (1966 rates for current tax calculation)	$ 298	$ 374
Old age security tax	96	N.A.
	$ 394	$ 374
5. Tax Credits		
Tax credit for first child	N.A.	0
Tax credit for additional children	N.A.	0
Tax credit for working mothers	N.A.	0
Additional tax credit for working mothers with pre-school children	N.A.	0
	0	0
6. Net Tax Paid	$ 394	$ 374

Note: "N.A." means that the item is not applicable.

CALCULATION OF TAXES UNDER THE CURRENT AND PROPOSED SYSTEMS
EXAMPLE 2: FAMILY WITH WIFE AND THREE CHILDREN
HUSBAND EARNING $6,500

	Current Tax Calculation	Tax Calculation Under the Proposed System
1. Income Received		
Income earned from employment	$6,500	$6,500
Family allowances ($6 per month per child)	N.A.	216
	$6,500	$6,716
2. Deductions		
Employment expense deduction	N.A.	$ 195
Personal exemptions	$2,000	N.A.
Dependant allowances	900	N.A.
Standard deduction	100	50
	$3,000	$ 245
3. Net Taxable Income	$3,500	$6,471
4. Gross Tax		
Income tax (1966 rates for current tax calculation)	$ 495	$ 741
Old age security tax	120	N.A.
	$ 615	$ 741
5. Tax Credits		
Tax credit for first child	N.A.	$ 100
Tax credit for additional children	N.A.	120
Tax credit for working mothers	N.A.	0
Additional tax credit for working mothers with pre-school children	N.A.	0
	0	$ 220
6. Net Tax Paid	$ 615	$ 521

Note: "N.A." means that the item is not applicable.

CALCULATION OF TAXES UNDER THE CURRENT AND PROPOSED SYSTEMS
EXAMPLE 3: FAMILY WITH TWO SCHOOL-AGE CHILDREN,
BOTH HUSBAND AND WIFE WORKING, HUSBAND EARNING
$5,200, WIFE EARNING $2,800

	Current Tax Calculation		Tax Calculation Under the Proposed System
	Husband's Return	Wife's Return	Family Return
1. Income Received			
Income earned from employment	$5,200	$2,800	$8,000
Family allowances ($6 per month per child)	N.A.	N.A.	144
	$5,200	$2,800	$8,144
2. Deductions			
Employment expense deduction	N.A.	N.A.	$ 240
Personal exemptions	$1,000	$1,000	N.A.
Dependant allowances	600	0	N.A.
Standard deduction	100	100	50
	$1,700	$1,100	$ 290
3. Net Taxable Income	$3,500	$1,700	$7,854
4. Gross Tax			
Income tax (1966 rates for current tax calculation)	$ 495	$ 188	$1,018
Old age security tax	120	68	N.A.
	$ 615	$ 256	$1,018
	$871		
5. Tax Credits			
Tax credit for first child	N.A.		$ 100
Tax credit for additional children	N.A.		60
Tax credit for working mothers	N.A.		80
Additional tax credit for working mothers with pre-school children	N.A.		0
	0		$ 240
6. Net Tax Paid	$871		$ 778

Note: "N.A." means that the item is not applicable.

TABLE I, 1–1

CHANGES IN TAX LIABILITIES UNDER THE PROPOSED TAX SYSTEM FOR AN UNATTACHED INDIVIDUAL AND A FAMILY UNIT WITH ONE INCOME RECIPIENT

GROSS EMPLOYMENT INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE — NUMBER OF CHILDREN: 0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	51.	0.	0.	0.	0.	0.	0.
	TAX UNDER OUR PROPOSALS	49.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–3.	0.	0.	0.	0.	0.	0.
2000	CURRENT TAX (1966 RATES)	115.	0.	0.	0.	0.	0.	0.
	TAX UNDER OUR PROPOSALS	119.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	3.	0.	0.	0.	0.	0.	0.
2500	CURRENT TAX (1966 RATES)	202.	51.	13.	0.	0.	0.	0.
	TAX UNDER OUR PROPOSALS	199.	36.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–3.	–15.	–13.	0.	0.	0.	0.
3000	CURRENT TAX (1966 RATES)	292.	115.	77.	38.	0.	0.	0.
	TAX UNDER OUR PROPOSALS	281.	99.	8.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–11.	–16.	–69.	–38.	0.	0.	0.
3500	CURRENT TAX (1966 RATES)	394.	202.	148.	102.	64.	0.	0.
	TAX UNDER OUR PROPOSALS	374.	172.	84.	35.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–20.	–30.	–64.	–67.	–64.	0.	0.
4000	CURRENT TAX (1966 RATES)	499.	292.	238.	184.	130.	51.	0.
	TAX UNDER OUR PROPOSALS	471.	250.	161.	113.	65.	0.	0.
	INCREASE OR DECREASE IN TAX	–28.	–42.	–77.	–71.	–65.	–51.	0.
5000	CURRENT TAX (1966 RATES)	691.	499.	436.	373.	310.	202.	64.
	TAX UNDER OUR PROPOSALS	681.	421.	334.	287.	240.	147.	8.
	INCREASE OR DECREASE IN TAX	–10.	–78.	–102.	–86.	–70.	–55.	–56.
6500	CURRENT TAX (1966 RATES)	1018.	798.	732.	672.	615.	499.	310.
	TAX UNDER OUR PROPOSALS	1016.	698.	612.	567.	521.	430.	293.
	INCREASE OR DECREASE IN TAX	–2.	–100.	–120.	–105.	–94.	–69.	–17.
8000	CURRENT TAX (1966 RATES)	1384.	1128.	1062.	996.	930.	798.	615.
	TAX UNDER OUR PROPOSALS	1365.	989.	903.	858.	812.	722.	587.
	INCREASE OR DECREASE IN TAX	–19.	–139.	–159.	–138.	–118.	–76.	–28.
10000	CURRENT TAX (1966 RATES)	1940.	1644.	1566.	1488.	1410.	1254.	1040.
	TAX UNDER OUR PROPOSALS	1864.	1393.	1309.	1264.	1219.	1129.	997.
	INCREASE OR DECREASE IN TAX	–76.	–251.	–257.	–224.	–191.	–125.	–43.
12000	CURRENT TAX (1966 RATES)	2585.	2240.	2150.	2060.	1970.	1790.	1540.
	TAX UNDER OUR PROPOSALS	2400.	1817.	1733.	1688.	1644.	1556.	1427.
	INCREASE OR DECREASE IN TAX	–185.	–423.	–417.	–372.	–326.	–234.	–113.
15000	CURRENT TAX (1966 RATES)	3730.	3330.	3210.	3090.	2970.	2760.	2445.
	TAX UNDER OUR PROPOSALS	3265.	2507.	2424.	2382.	2339.	2253.	2128.
	INCREASE OR DECREASE IN TAX	–465.	–823.	–786.	–708.	–631.	–507.	–317.
20000	CURRENT TAX (1966 RATES)	5925.	5475.	5340.	5205.	5070.	4800.	4395.
	TAX UNDER OUR PROPOSALS	4839.	3828.	3748.	3707.	3667.	3586.	3465.
	INCREASE OR DECREASE IN TAX	–1086.	–1647.	–1592.	–1498.	–1403.	–1214.	–930.
25000	CURRENT TAX (1966 RATES)	8175.	7725.	7590.	7455.	7320.	7050.	6645.
	TAX UNDER OUR PROPOSALS	6572.	5356.	5279.	5241.	5203.	5128.	5016.
	INCREASE OR DECREASE IN TAX	–1603.	–2369.	–2311.	–2214.	–2117.	–1922.	–1629.
30000	CURRENT TAX (1966 RATES)	10620.	10120.	9970.	9820.	9670.	9370.	8920.
	TAX UNDER OUR PROPOSALS	8411.	7084.	7010.	6975.	6940.	6870.	6767.
	INCREASE OR DECREASE IN TAX	–2209.	–3036.	–2960.	–2845.	–2730.	–2500.	–2153.
40000	CURRENT TAX (1966 RATES)	15620.	15120.	14970.	14820.	14670.	14370.	13920.
	TAX UNDER OUR PROPOSALS	12300.	10868.	10795.	10763.	10730.	10665.	10568.
	INCREASE OR DECREASE IN TAX	–3320.	–4252.	–4175.	–4057.	–3940.	–3705.	–3352.
50000	CURRENT TAX (1966 RATES)	21065.	20515.	20350.	20185.	20020.	19690.	19195.
	TAX UNDER OUR PROPOSALS	16484.	15046.	14976.	14946.	14917.	14857.	14768.
	INCREASE OR DECREASE IN TAX	–4581.	–5469.	–5374.	–5239.	–5103.	–4833.	–4427.
70000	CURRENT TAX (1966 RATES)	32510.	31910.	31730.	31550.	31370.	31010.	30470.
	TAX UNDER OUR PROPOSALS	25462.	24024.	23957.	23930.	23903.	23850.	23769.
	INCREASE OR DECREASE IN TAX	–7048.	–7886.	–7773.	–7620.	–7467.	–7160.	–6701.
100000	CURRENT TAX (1966 RATES)	50955.	50305.	50110.	49915.	49720.	49330.	48745.
	TAX UNDER OUR PROPOSALS	39845.	38407.	38343.	38318.	38293.	38244.	38170.
	INCREASE OR DECREASE IN TAX	–11110.	–11898.	–11767.	–11597.	–11427.	–11086.	–10575.
200000	CURRENT TAX (1966 RATES)	119650.	118950.	118740.	118530.	118320.	117900.	117270.
	TAX UNDER OUR PROPOSALS	89840.	88402.	88338.	88314.	88290.	88242.	88170.
	INCREASE OR DECREASE IN TAX	–29810.	–30548.	–30402.	–30216.	–30030.	–29658.	–29100.

Note: See assumptions in Appendix I.

TABLE I, 1–2

EFFECTIVE AVERAGE TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS FOR AN UNATTACHED INDIVIDUAL AND A FAMILY UNIT WITH ONE INCOME RECIPIENT

GROSS EMPLOYMENT INCOME		STATUS OF TAXPAYER						
		UNATTACHED INDIVIDUAL	MARRIED COUPLE					
			NUMBER OF CHILDREN					
			0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.034	0.000	0.000	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.032	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.002	0.000	0.000	0.000	0.000	0.000	0.000
2000	CURRENT TAX (1966 RATES)	0.058	0.000	0.000	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.059	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	0.002	0.000	0.000	0.000	0.000	0.000	0.000
2500	CURRENT TAX (1966 RATES)	0.081	0.020	0.005	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.079	0.014	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.001	–0.006	–0.005	0.000	0.000	0.000	0.000
3000	CURRENT TAX (1966 RATES)	0.097	0.038	0.026	0.013	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.094	0.033	0.003	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.004	–0.005	–0.023	–0.013	0.000	0.000	0.000
3500	CURRENT TAX (1966 RATES)	0.113	0.058	0.042	0.029	0.018	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.107	0.049	0.024	0.010	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.006	–0.009	–0.018	–0.019	–0.018	0.000	0.000
4000	CURRENT TAX (1966 RATES)	0.125	0.073	0.059	0.046	0.032	0.013	0.000
	TAX UNDER OUR PROPOSALS	0.118	0.062	0.040	0.028	0.016	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.007	–0.011	–0.019	–0.018	–0.016	–0.013	0.000
5000	CURRENT TAX (1966 RATES)	0.138	0.100	0.087	0.075	0.062	0.040	0.013
	TAX UNDER OUR PROPOSALS	0.136	0.084	0.067	0.057	0.048	0.029	0.002
	CHANGE IN EFFECTIVE RATE	–0.002	–0.016	–0.020	–0.017	–0.014	–0.011	–0.011
6500	CURRENT TAX (1966 RATES)	0.157	0.123	0.113	0.103	0.095	0.077	0.048
	TAX UNDER OUR PROPOSALS	0.156	0.107	0.094	0.087	0.080	0.066	0.045
	CHANGE IN EFFECTIVE RATE	–0.000	–0.015	–0.018	–0.016	–0.014	–0.011	–0.003
8000	CURRENT TAX (1966 RATES)	0.173	0.141	0.133	0.124	0.116	0.100	0.077
	TAX UNDER OUR PROPOSALS	0.171	0.124	0.113	0.107	0.102	0.090	0.073
	CHANGE IN EFFECTIVE RATE	–0.002	–0.017	–0.020	–0.017	–0.015	–0.010	–0.003
10000	CURRENT TAX (1966 RATES)	0.194	0.164	0.157	0.149	0.141	0.125	0.104
	TAX UNDER OUR PROPOSALS	0.186	0.139	0.131	0.126	0.122	0.113	0.100
	CHANGE IN EFFECTIVE RATE	–0.008	–0.025	–0.026	–0.022	–0.019	–0.012	–0.004
12000	CURRENT TAX (1966 RATES)	0.215	0.187	0.179	0.172	0.164	0.149	0.128
	TAX UNDER OUR PROPOSALS	0.200	0.151	0.144	0.141	0.137	0.130	0.119
	CHANGE IN EFFECTIVE RATE	–0.015	–0.035	–0.035	–0.031	–0.027	–0.020	–0.009
15000	CURRENT TAX (1966 RATES)	0.249	0.222	0.214	0.206	0.198	0.184	0.163
	TAX UNDER OUR PROPOSALS	0.218	0.167	0.162	0.159	0.156	0.150	0.142
	CHANGE IN EFFECTIVE RATE	–0.031	–0.055	–0.052	–0.047	–0.042	–0.034	–0.021
20000	CURRENT TAX (1966 RATES)	0.296	0.274	0.267	0.260	0.253	0.240	0.220
	TAX UNDER OUR PROPOSALS	0.242	0.191	0.187	0.185	0.183	0.179	0.173
	CHANGE IN EFFECTIVE RATE	–0.054	–0.082	–0.080	–0.075	–0.070	–0.061	–0.046
25000	CURRENT TAX (1966 RATES)	0.327	0.309	0.304	0.298	0.293	0.282	0.266
	TAX UNDER OUR PROPOSALS	0.263	0.214	0.211	0.210	0.208	0.205	0.201
	CHANGE IN EFFECTIVE RATE	–0.064	–0.095	–0.092	–0.089	–0.085	–0.077	–0.065
30000	CURRENT TAX (1966 RATES)	0.354	0.337	0.332	0.327	0.322	0.312	0.297
	TAX UNDER OUR PROPOSALS	0.280	0.236	0.234	0.232	0.231	0.229	0.226
	CHANGE IN EFFECTIVE RATE	–0.074	–0.101	–0.099	–0.095	–0.091	–0.083	–0.072
40000	CURRENT TAX (1966 RATES)	0.390	0.378	0.374	0.370	0.367	0.359	0.348
	TAX UNDER OUR PROPOSALS	0.308	0.272	0.270	0.269	0.268	0.267	0.264
	CHANGE IN EFFECTIVE RATE	–0.083	–0.106	–0.104	–0.101	–0.098	–0.093	–0.084
50000	CURRENT TAX (1966 RATES)	0.421	0.410	0.407	0.404	0.400	0.394	0.384
	TAX UNDER OUR PROPOSALS	0.330	0.301	0.300	0.299	0.298	0.297	0.295
	CHANGE IN EFFECTIVE RATE	–0.092	–0.109	–0.107	–0.105	–0.102	–0.097	–0.089
70000	CURRENT TAX (1966 RATES)	0.464	0.456	0.453	0.451	0.448	0.443	0.435
	TAX UNDER OUR PROPOSALS	0.364	0.343	0.342	0.342	0.341	0.341	0.340
	CHANGE IN EFFECTIVE RATE	–0.101	–0.113	–0.111	–0.109	–0.107	–0.102	–0.096
100000	CURRENT TAX (1966 RATES)	0.510	0.503	0.501	0.499	0.497	0.493	0.487
	TAX UNDER OUR PROPOSALS	0.398	0.384	0.383	0.383	0.383	0.382	0.382
	CHANGE IN EFFECTIVE RATE	–0.111	–0.119	–0.118	–0.116	–0.114	–0.111	–0.106
200000	CURRENT TAX (1966 RATES)	0.598	0.595	0.594	0.593	0.592	0.589	0.586
	TAX UNDER OUR PROPOSALS	0.449	0.442	0.442	0.442	0.441	0.441	0.441
	CHANGE IN EFFECTIVE RATE	–0.149	–0.153	–0.152	–0.151	–0.150	–0.148	–0.146

Note: See assumptions in Appendix I.

TABLE I, 1–3

EFFECTIVE MARGINAL TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS FOR AN UNATTACHED INDIVIDUAL AND A FAMILY UNIT WITH ONE INCOME RECIPIENT

GROSS EMPLOYMENT INCOME		STATUS OF TAXPAYER						
		UNATTACHED INDIVIDUAL	MARRIED COUPLE					
			NUMBER OF CHILDREN					
			0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.128	0.000	0.000	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.140	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	0.012	0.000	0.000	0.000	0.000	0.000	0.000
2000	CURRENT TAX (1966 RATES)	0.174	0.102	0.026	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.160	0.071	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.013	–0.031	–0.026	0.000	0.000	0.000	0.000
2500	CURRENT TAX (1966 RATES)	0.180	0.128	0.128	0.077	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.165	0.126	0.016	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.015	–0.002	–0.112	–0.077	0.000	0.000	0.000
3000	CURRENT TAX (1966 RATES)	0.204	0.174	0.142	0.128	0.128	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.186	0.147	0.151	0.070	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.018	–0.027	0.009	–0.058	–0.128	0.000	0.000
3500	CURRENT TAX (1966 RATES)	0.210	0.180	0.180	0.163	0.132	0.102	0.000
	TAX UNDER OUR PROPOSALS	0.194	0.155	0.155	0.155	0.131	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.016	–0.025	–0.025	–0.008	–0.001	–0.102	0.000
4000	CURRENT TAX (1966 RATES)	0.194	0.204	0.186	0.180	0.180	0.128	0.000
	TAX UNDER OUR PROPOSALS	0.207	0.168	0.171	0.174	0.175	0.117	0.000
	CHANGE IN MARGINAL RATE	0.013	–0.036	–0.015	–0.006	–0.005	–0.011	0.000
5000	CURRENT TAX (1966 RATES)	0.214	0.194	0.206	0.210	0.210	0.180	0.132
	TAX UNDER OUR PROPOSALS	0.219	0.180	0.182	0.183	0.184	0.184	0.184
	CHANGE IN MARGINAL RATE	0.005	–0.014	–0.024	–0.027	–0.026	0.004	0.052
6500	CURRENT TAX (1966 RATES)	0.220	0.220	0.220	0.208	0.190	0.194	0.210
	TAX UNDER OUR PROPOSALS	0.233	0.194	0.194	0.194	0.194	0.194	0.194
	CHANGE IN MARGINAL RATE	0.013	–0.026	–0.026	–0.014	0.004	0.000	–0.016
8000	CURRENT TAX (1966 RATES)	0.260	0.252	0.228	0.220	0.220	0.220	0.190
	TAX UNDER OUR PROPOSALS	0.241	0.198	0.199	0.201	0.202	0.204	0.204
	CHANGE IN MARGINAL RATE	–0.019	–0.054	–0.029	–0.019	–0.018	–0.016	0.014
10000	CURRENT TAX (1966 RATES)	0.300	0.292	0.268	0.260	0.260	0.260	0.220
	TAX UNDER OUR PROPOSALS	0.258	0.206	0.208	0.209	0.211	0.213	0.213
	CHANGE IN MARGINAL RATE	–0.042	–0.086	–0.060	–0.051	–0.049	–0.047	–0.007
12000	CURRENT TAX (1966 RATES)	0.350	0.340	0.310	0.300	0.300	0.300	0.260
	TAX UNDER OUR PROPOSALS	0.275	0.216	0.219	0.222	0.225	0.231	0.233
	CHANGE IN MARGINAL RATE	–0.075	–0.124	–0.091	–0.078	–0.075	–0.069	–0.027
15000	CURRENT TAX (1966 RATES)	0.400	0.400	0.400	0.400	0.400	0.350	0.350
	TAX UNDER OUR PROPOSALS	0.291	0.233	0.236	0.241	0.245	0.253	0.262
	CHANGE IN MARGINAL RATE	–0.109	–0.167	–0.164	–0.159	–0.155	–0.096	–0.088
20000	CURRENT TAX (1966 RATES)	0.450	0.450	0.450	0.450	0.450	0.450	0.450
	TAX UNDER OUR PROPOSALS	0.320	0.270	0.272	0.278	0.283	0.295	0.310
	CHANGE IN MARGINAL RATE	–0.130	–0.180	–0.178	–0.172	–0.167	–0.155	–0.140
25000	CURRENT TAX (1966 RATES)	0.450	0.450	0.450	0.450	0.450	0.450	0.450
	TAX UNDER OUR PROPOSALS	0.350	0.310	0.312	0.318	0.323	0.335	0.350
	CHANGE IN MARGINAL RATE	–0.100	–0.140	–0.138	–0.132	–0.127	–0.115	–0.100
30000	CURRENT TAX (1966 RATES)	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	TAX UNDER OUR PROPOSALS	0.370	0.350	0.351	0.356	0.360	0.369	0.380
	CHANGE IN MARGINAL RATE	–0.130	–0.150	–0.149	–0.144	–0.140	–0.131	–0.120
40000	CURRENT TAX (1966 RATES)	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	TAX UNDER OUR PROPOSALS	0.390	0.380	0.382	0.388	0.393	0.405	0.420
	CHANGE IN MARGINAL RATE	–0.110	–0.120	–0.118	–0.112	–0.107	–0.095	–0.080
50000	CURRENT TAX (1966 RATES)	0.550	0.550	0.550	0.550	0.550	0.550	0.550
	TAX UNDER OUR PROPOSALS	0.420	0.420	0.421	0.424	0.427	0.432	0.440
	CHANGE IN MARGINAL RATE	–0.130	–0.130	–0.129	–0.126	–0.123	–0.118	–0.110
70000	CURRENT TAX (1966 RATES)	0.600	0.600	0.600	0.600	0.600	0.600	0.600
	TAX UNDER OUR PROPOSALS	0.460	0.460	0.460	0.460	0.460	0.460	0.460
	CHANGE IN MARGINAL RATE	–0.140	–0.140	–0.140	–0.140	–0.140	–0.140	–0.140
100000	CURRENT TAX (1966 RATES)	0.650	0.650	0.650	0.650	0.650	0.650	0.650
	TAX UNDER OUR PROPOSALS	0.490	0.490	0.490	0.492	0.493	0.496	0.500
	CHANGE IN MARGINAL RATE	–0.160	–0.160	–0.160	–0.158	–0.157	–0.154	–0.150
200000	CURRENT TAX (1966 RATES)	0.700	0.700	0.700	0.700	0.700	0.700	0.700
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	–0.200	–0.200	–0.200	–0.200	–0.200	–0.200	–0.200

Note: See assumptions in Appendix I.

TABLE I, 2–1

CHANGES IN TAX LIABILITIES UNDER THE PROPOSED TAX SYSTEM FOR A FAMILY UNIT WITH 20 PER CENT OF ITS INCOME FROM A WORKING WIFE

GROSS EMPLOYMENT INCOME		STATUS OF TAXPAYER					
		MARRIED COUPLE					
		NUMBER OF CHILDREN					
		0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.	0.	0.	0.	0.	0.
	TAX UNDER OUR PROPOSALS	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	0.	0.	0.	0.	0.	0.
2000	CURRENT TAX (1966 RATES)	0.	0.	0.	0.	0.	0.
	TAX UNDER OUR PROPOSALS	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	0.	0.	0.	0.	0.	0.
2500	CURRENT TAX (1966 RATES)	19.	0.	0.	0.	0.	0.
	TAX UNDER OUR PROPOSALS	36.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	17.	0.	0.	0.	0.	0.
3000	CURRENT TAX (1966 RATES)	83.	45.	6.	0.	0.	0.
	TAX UNDER OUR PROPOSALS	99.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	16.	–45.	–6.	0.	0.	0.
3500	CURRENT TAX (1966 RATES)	157.	109.	70.	32.	0.	0.
	TAX UNDER OUR PROPOSALS	172.	4.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	15.	–105.	–70.	–32.	0.	0.
4000	CURRENT TAX (1966 RATES)	247.	193.	139.	96.	19.	0.
	TAX UNDER OUR PROPOSALS	250.	81.	33.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	3.	–112.	–106.	–96.	–19.	0.
5000	CURRENT TAX (1966 RATES)	446.	383.	320.	265.	157.	32.
	TAX UNDER OUR PROPOSALS	421.	254.	207.	160.	67.	0.
	INCREASE OR DECREASE IN TAX	–25.	–130.	–114.	–105.	–90.	–32.
6500	CURRENT TAX (1966 RATES)	758.	698.	641.	584.	462.	282.
	TAX UNDER OUR PROPOSALS	698.	532.	487.	441.	350.	213.
	INCREASE OR DECREASE IN TAX	–60.	–165.	–154.	–142.	–112.	–68.
8000	CURRENT TAX (1966 RATES)	1060.	994.	928.	862.	736.	563.
	TAX UNDER OUR PROPOSALS	989.	823.	778.	732.	642.	507.
	INCREASE OR DECREASE IN TAX	–71.	–171.	–150.	–130.	–94.	–56.
10000	CURRENT TAX (1966 RATES)	1499.	1421.	1343.	1265.	1133.	935.
	TAX UNDER OUR PROPOSALS	1393.	1229.	1184.	1139.	1049.	917.
	INCREASE OR DECREASE IN TAX	–106.	–193.	–159.	–126.	–84.	–18.
12000	CURRENT TAX (1966 RATES)	2004.	1914.	1828.	1750.	1594.	1360.
	TAX UNDER OUR PROPOSALS	1817.	1653.	1608.	1564.	1476.	1347.
	INCREASE OR DECREASE IN TAX	–187.	–261.	–220.	–186.	–118.	–13.
15000	CURRENT TAX (1966 RATES)	2877.	2772.	2667.	2562.	2382.	2112.
	TAX UNDER OUR PROPOSALS	2507.	2344.	2302.	2259.	2173.	2048.
	INCREASE OR DECREASE IN TAX	–370.	–428.	–365.	–303.	–209.	–64.
20000	CURRENT TAX (1966 RATES)	4629.	4509.	4389.	4269.	4029.	3669.
	TAX UNDER OUR PROPOSALS	3828.	3668.	3627.	3587.	3506.	3385.
	INCREASE OR DECREASE IN TAX	–800.	–841.	–762.	–682.	–523.	–284.
25000	CURRENT TAX (1966 RATES)	6616.	6481.	6346.	6211.	5941.	5336.
	TAX UNDER OUR PROPOSALS	5356.	5199.	5161.	5123.	5048.	4936.
	INCREASE OR DECREASE IN TAX	–1260.	–1282.	–1185.	–1088.	–893.	–600.
30000	CURRENT TAX (1966 RATES)	8633.	8498.	8363.	8228.	7958.	7553.
	TAX UNDER OUR PROPOSALS	7084.	6930.	6895.	6860.	6790.	6687.
	INCREASE OR DECREASE IN TAX	–1549.	–1568.	–1468.	–1368.	–1168.	–866.
40000	CURRENT TAX (1966 RATES)	13004.	12854.	12704.	12554.	12254.	11804.
	TAX UNDER OUR PROPOSALS	10868.	10715.	10683.	10650.	10585.	10488.
	INCREASE OR DECREASE IN TAX	–2136.	–2139.	–2021.	–1904.	–1669.	–1316.
50000	CURRENT TAX (1966 RATES)	17560.	17410.	17260.	17110.	16810.	16360.
	TAX UNDER OUR PROPOSALS	15046.	14896.	14866.	14837.	14777.	14688.
	INCREASE OR DECREASE IN TAX	–2514.	–2514.	–2394.	–2273.	–2033.	–1672.
70000	CURRENT TAX (1966 RATES)	27695.	27530.	27365.	27200.	26870.	26375.
	TAX UNDER OUR PROPOSALS	24024.	23877.	23850.	23823.	23770.	23689.
	INCREASE OR DECREASE IN TAX	–3671.	–3653.	–3515.	–3377.	–3100.	–2686.
100000	CURRENT TAX (1966 RATES)	44435.	44255.	44075.	43895.	43535.	42995.
	TAX UNDER OUR PROPOSALS	38407.	38263.	38238.	38213.	38164.	38090.
	INCREASE OR DECREASE IN TAX	–6028.	–5992.	–5837.	–5682.	–5371.	–4905.
200000	CURRENT TAX (1966 RATES)	107270.	107060.	106850.	106640.	106220.	105590.
	TAX UNDER OUR PROPOSALS	88402.	88258.	88234.	88210.	88162.	88090.
	INCREASE OR DECREASE IN TAX	–18868.	–18802.	–18616.	–18430.	–18058.	–17500.

Note: See assumptions in Appendix I.

TABLE I, 2–2

EFFECTIVE AVERAGE TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS FOR A FAMILY UNIT WITH 20 PER CENT OF ITS INCOME FROM A WORKING WIFE

GROSS EMPLOYMENT INCOME		STATUS OF TAXPAYER — MARRIED COUPLE — NUMBER OF CHILDREN 0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.000	0.000	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	0.000	0.000	0.000	0.000	0.000	0.000
2000	CURRENT TAX (1966 RATES)	0.000	0.000	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	0.000	0.000	0.000	0.000	0.000	0.000
2500	CURRENT TAX (1966 RATES)	0.008	0.000	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.014	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	0.007	0.000	0.000	0.000	0.000	0.000
3000	CURRENT TAX (1966 RATES)	0.028	0.015	0.002	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.033	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	0.005	−0.015	−0.002	0.000	0.000	0.000
3500	CURRENT TAX (1966 RATES)	0.045	0.031	0.020	0.009	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.049	0.001	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	0.004	−0.030	−0.020	−0.009	0.000	0.000
4000	CURRENT TAX (1966 RATES)	0.062	0.048	0.035	0.024	0.005	0.000
	TAX UNDER OUR PROPOSALS	0.062	0.020	0.008	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	0.001	−0.028	−0.027	−0.024	−0.005	0.000
5000	CURRENT TAX (1966 RATES)	0.089	0.077	0.064	0.053	0.031	0.006
	TAX UNDER OUR PROPOSALS	0.084	0.051	0.041	0.032	0.013	0.000
	CHANGE IN EFFECTIVE RATE	−0.005	−0.026	−0.023	−0.021	−0.018	−0.006
6500	CURRENT TAX (1966 RATES)	0.117	0.107	0.099	0.090	0.071	0.043
	TAX UNDER OUR PROPOSALS	0.107	0.082	0.075	0.068	0.054	0.033
	CHANGE IN EFFECTIVE RATE	−0.009	−0.025	−0.024	−0.022	−0.017	−0.011
8000	CURRENT TAX (1966 RATES)	0.132	0.124	0.116	0.108	0.092	0.070
	TAX UNDER OUR PROPOSALS	0.124	0.103	0.097	0.092	0.080	0.063
	CHANGE IN EFFECTIVE RATE	−0.009	−0.021	−0.019	−0.016	−0.012	−0.007
10000	CURRENT TAX (1966 RATES)	0.150	0.142	0.134	0.127	0.113	0.094
	TAX UNDER OUR PROPOSALS	0.139	0.123	0.118	0.114	0.105	0.092
	CHANGE IN EFFECTIVE RATE	−0.011	−0.019	−0.016	−0.013	−0.008	−0.002
12000	CURRENT TAX (1966 RATES)	0.167	0.159	0.152	0.146	0.133	0.113
	TAX UNDER OUR PROPOSALS	0.151	0.138	0.134	0.130	0.123	0.112
	CHANGE IN EFFECTIVE RATE	−0.016	−0.022	−0.018	−0.015	−0.010	−0.001
15000	CURRENT TAX (1966 RATES)	0.192	0.185	0.178	0.171	0.159	0.141
	TAX UNDER OUR PROPOSALS	0.167	0.156	0.153	0.151	0.145	0.137
	CHANGE IN EFFECTIVE RATE	−0.025	−0.029	−0.024	−0.020	−0.014	−0.004
20000	CURRENT TAX (1966 RATES)	0.231	0.225	0.219	0.213	0.201	0.183
	TAX UNDER OUR PROPOSALS	0.191	0.183	0.181	0.179	0.175	0.169
	CHANGE IN EFFECTIVE RATE	−0.040	−0.042	−0.038	−0.034	−0.026	−0.014
25000	CURRENT TAX (1966 RATES)	0.265	0.259	0.254	0.248	0.238	0.221
	TAX UNDER OUR PROPOSALS	0.214	0.208	0.206	0.205	0.202	0.197
	CHANGE IN EFFECTIVE RATE	−0.050	−0.051	−0.047	−0.044	−0.036	−0.024
30000	CURRENT TAX (1966 RATES)	0.288	0.283	0.279	0.274	0.265	0.252
	TAX UNDER OUR PROPOSALS	0.236	0.231	0.230	0.229	0.226	0.223
	CHANGE IN EFFECTIVE RATE	−0.052	−0.052	−0.049	−0.046	−0.039	−0.029
40000	CURRENT TAX (1966 RATES)	0.325	0.321	0.318	0.314	0.306	0.295
	TAX UNDER OUR PROPOSALS	0.272	0.268	0.267	0.266	0.265	0.262
	CHANGE IN EFFECTIVE RATE	−0.053	−0.053	−0.051	−0.048	−0.042	−0.033
50000	CURRENT TAX (1966 RATES)	0.351	0.348	0.345	0.342	0.336	0.327
	TAX UNDER OUR PROPOSALS	0.301	0.298	0.297	0.297	0.296	0.294
	CHANGE IN EFFECTIVE RATE	−0.050	−0.050	−0.048	−0.045	−0.041	−0.033
70000	CURRENT TAX (1966 RATES)	0.396	0.393	0.391	0.389	0.384	0.377
	TAX UNDER OUR PROPOSALS	0.343	0.341	0.341	0.340	0.340	0.338
	CHANGE IN EFFECTIVE RATE	−0.052	−0.052	−0.050	−0.048	−0.044	−0.038
100000	CURRENT TAX (1966 RATES)	0.444	0.443	0.441	0.439	0.435	0.430
	TAX UNDER OUR PROPOSALS	0.384	0.383	0.382	0.382	0.382	0.371
	CHANGE IN EFFECTIVE RATE	−0.060	−0.060	−0.058	−0.057	−0.054	−0.049
200000	CURRENT TAX (1966 RATES)	0.536	0.535	0.534	0.533	0.531	0.528
	TAX UNDER OUR PROPOSALS	0.442	0.441	0.441	0.441	0.441	0.440
	CHANGE IN EFFECTIVE RATE	−0.094	−0.094	−0.093	−0.092	−0.090	−0.087

Note: See Assumptions in Appendix I.

TABLE I, 2-3

EFFECTIVE MARGINAL TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS FOR A FAMILY UNIT WITH 20 PER CENT OF ITS INCOME FROM A WORKING WIFE

GROSS EMPLOYMENT INCOME		STATUS OF TAXPAYER					
		MARRIED COUPLE					
		NUMBER OF CHILDREN					
		0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.000	0.000	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	0.000	0.000	0.000	0.000	0.000	0.000
2000	CURRENT TAX (1966 RATES)	0.038	0.000	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.071	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	0.033	0.000	0.000	0.000	0.000	0.000
2500	CURRENT TAX (1966 RATES)	0.128	0.090	0.013	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.126	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.002	−0.090	−0.013	0.000	0.000	0.000
3000	CURRENT TAX (1966 RATES)	0.148	0.128	0.128	0.064	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.147	0.007	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.001	−0.121	−0.128	−0.064	0.000	0.000
3500	CURRENT TAX (1966 RATES)	0.180	0.168	0.137	0.128	0.038	0.000
	TAX UNDER OUR PROPOSALS	0.155	0.155	0.066	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.025	−0.013	−0.072	−0.128	−0.038	0.000
4000	CURRENT TAX (1966 RATES)	0.189	0.180	0.180	0.158	0.128	0.000
	TAX UNDER OUR PROPOSALS	0.168	0.171	0.174	0.145	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.021	−0.009	−0.006	−0.013	−0.128	0.000
5000	CURRENT TAX (1966 RATES)	0.204	0.210	0.210	0.195	0.180	0.128
	TAX UNDER OUR PROPOSALS	0.180	0.182	0.183	0.184	0.184	0.041
	CHANGE IN MARGINAL RATE	−0.024	−0.028	−0.027	−0.011	0.004	−0.087
6500	CURRENT TAX (1966 RATES)	0.202	0.190	0.178	0.178	0.194	0.176
	TAX UNDER OUR PROPOSALS	0.194	0.194	0.194	0.194	0.194	0.194
	CHANGE IN MARGINAL RATE	−0.008	0.004	0.016	0.016	0.000	0.018
8000	CURRENT TAX (1966 RATES)	0.202	0.202	0.202	0.202	0.190	0.182
	TAX UNDER OUR PROPOSALS	0.198	0.199	0.201	0.202	0.204	0.204
	CHANGE IN MARGINAL RATE	−0.004	−0.002	−0.001	0.001	0.014	0.022
10000	CURRENT TAX (1966 RATES)	0.238	0.238	0.238	0.238	0.206	0.206
	TAX UNDER OUR PROPOSALS	0.206	0.208	0.209	0.211	0.213	0.213
	CHANGE IN MARGINAL RATE	−0.031	−0.030	−0.028	−0.027	0.008	0.008
12000	CURRENT TAX (1966 RATES)	0.276	0.276	0.268	0.244	0.244	0.244
	TAX UNDER OUR PROPOSALS	0.216	0.219	0.222	0.225	0.231	0.233
	CHANGE IN MARGINAL RATE	−0.060	−0.057	−0.046	−0.019	−0.013	−0.011
15000	CURRENT TAX (1966 RATES)	0.316	0.316	0.316	0.316	0.276	0.276
	TAX UNDER OUR PROPOSALS	0.233	0.236	0.241	0.245	0.253	0.262
	CHANGE IN MARGINAL RATE	−0.083	−0.080	−0.075	−0.071	−0.022	−0.014
20000	CURRENT TAX (1966 RATES)	0.392	0.362	0.362	0.362	0.362	0.362
	TAX UNDER OUR PROPOSALS	0.270	0.272	0.278	0.283	0.295	0.310
	CHANGE IN MARGINAL RATE	−0.122	−0.090	−0.084	−0.079	−0.067	−0.052
25000	CURRENT TAX (1966 RATES)	0.398	0.398	0.398	0.398	0.398	0.398
	TAX UNDER OUR PROPOSALS	0.310	0.312	0.318	0.323	0.335	0.350
	CHANGE IN MARGINAL RATE	−0.088	−0.086	−0.080	−0.075	−0.063	−0.048
30000	CURRENT TAX (1966 RATES)	0.404	0.404	0.404	0.404	0.404	0.404
	TAX UNDER OUR PROPOSALS	0.350	0.351	0.356	0.360	0.369	0.380
	CHANGE IN MARGINAL RATE	−0.054	−0.053	−0.048	−0.044	−0.035	−0.024
40000	CURRENT TAX (1966 RATES)	0.452	0.452	0.452	0.452	0.452	0.452
	TAX UNDER OUR PROPOSALS	0.380	0.382	0.388	0.393	0.405	0.420
	CHANGE IN MARGINAL RATE	−0.072	−0.070	−0.064	−0.059	−0.047	−0.032
50000	CURRENT TAX (1966 RATES)	0.460	0.460	0.460	0.460	0.460	0.460
	TAX UNDER OUR PROPOSALS	0.420	0.421	0.424	0.427	0.432	0.440
	CHANGE IN MARGINAL RATE	−0.040	−0.039	−0.036	−0.033	−0.028	−0.020
70000	CURRENT TAX (1966 RATES)	0.520	0.520	0.520	0.520	0.520	0.520
	TAX UNDER OUR PROPOSALS	0.460	0.460	0.460	0.460	0.460	0.460
	CHANGE IN MARGINAL RATE	−0.060	−0.060	−0.060	−0.060	−0.060	−0.060
100000	CURRENT TAX (1966 RATES)	0.570	0.570	0.570	0.570	0.570	0.570
	TAX UNDER OUR PROPOSALS	0.490	0.490	0.492	0.493	0.496	0.500
	CHANGE IN MARGINAL RATE	−0.080	−0.080	−0.078	−0.077	−0.074	−0.070
200000	CURRENT TAX (1966 RATES)	0.660	0.660	0.660	0.660	0.660	0.660
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	−0.160	−0.160	-0.160	−0.160	−0.160	−0.160

Note: See assumptions in Appendix I.

TABLE I, 3–1

CHANGES IN TAX LIABILITIES UNDER THE PROPOSED TAX SYSTEM FOR A FAMILY UNIT WITH 35 PER CENT OF ITS INCOME FROM A WORKING WIFE

GROSS EMPLOYMENT INCOME		STATUS OF TAXPAYER — MARRIED COUPLE — NUMBER OF CHILDREN					
		0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.	0.	0.	0.	0.	0.
	TAX UNDER OUR PROPOSALS	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	0.	0.	0.	0.	0.	0.
2000	CURRENT TAX (1966 RATES)	0.	0.	0.	0.	0.	0.
	TAX UNDER OUR PROPOSALS	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	0.	0.	0.	0.	0.	0.
2500	CURRENT TAX (1966 RATES)	19.	0.	0.	0.	0.	0.
	TAX UNDER OUR PROPOSALS	36.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	17.	0.	0.	0.	0.	0.
3000	CURRENT TAX (1966 RATES)	83.	45.	6.	0.	0.	0.
	TAX UNDER OUR PROPOSALS	99.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	16.	–45.	–6.	0.	0.	0.
3500	CURRENT TAX (1966 RATES)	173.	125.	86.	48.	0.	0.
	TAX UNDER OUR PROPOSALS	172.	4.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–1.	–121.	–86.	–48.	0.	0.
4000	CURRENT TAX (1966 RATES)	258.	204.	154.	115.	38.	0.
	TAX UNDER OUR PROPOSALS	250.	81.	33.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–9.	–123.	–121.	–115.	–38.	0.
5000	CURRENT TAX (1966 RATES)	425.	366.	312.	258.	166.	51.
	TAX UNDER OUR PROPOSALS	421.	254.	207.	160.	67.	0.
	INCREASE OR DECREASE IN TAX	–4.	–112.	–105.	–98.	–99.	–51.
6500	CURRENT TAX (1966 RATES)	705.	645.	582.	519.	404.	247.
	TAX UNDER OUR PROPOSALS	698.	532.	487.	441.	350.	213.
	INCREASE OR DECREASE IN TAX	–7.	–112.	–95.	–78.	–54.	–33.
8000	CURRENT TAX (1966 RATES)	988.	928.	871.	814.	692.	512.
	TAX UNDER OUR PROPOSALS	989.	823.	778.	732.	642.	507.
	INCREASE OR DECREASE IN TAX	1.	–105.	–93.	–82.	–50.	–5.
10000	CURRENT TAX (1966 RATES)	1412.	1346.	1280.	1214.	1085.	908.
	TAX UNDER OUR PROPOSALS	1393.	1229.	1184.	1139.	1049.	917.
	INCREASE OR DECREASE IN TAX	–19.	–117.	–96.	–75.	–36.	9.
12000	CURRENT TAX (1966 RATES)	1871.	1793.	1715.	1645.	1513.	1315.
	TAX UNDER OUR PROPOSALS	1817.	1653.	1608.	1564.	1476.	1347.
	INCREASE OR DECREASE IN TAX	–54.	–140.	–107.	–81.	–37.	32.
15000	CURRENT TAX (1966 RATES)	2608.	2518.	2428.	2348.	2192.	1958.
	TAX UNDER OUR PROPOSALS	2507.	2344.	2302.	2259.	2173.	2048.
	INCREASE OR DECREASE IN TAX	–101.	–174.	–126.	–89.	–19.	90.
20000	CURRENT TAX (1966 RATES)	4063.	3958.	3853.	3748.	3538.	3248.
	TAX UNDER OUR PROPOSALS	3828.	3668.	3627.	3587.	3506.	3385.
	INCREASE OR DECREASE IN TAX	–235.	–290.	–226.	–161.	–32.	137.
25000	CURRENT TAX (1966 RATES)	5816.	5689.	5569.	5449.	5209.	4849.
	TAX UNDER OUR PROPOSALS	5356.	5199.	5161.	5123.	5048.	4936.
	INCREASE OR DECREASE IN TAX	–460.	–490.	–408.	–326.	–161.	87.
30000	CURRENT TAX (1966 RATES)	7790.	7655.	7520.	7385.	7115.	6710.
	TAX UNDER OUR PROPOSALS	7084.	6930.	6895.	6860.	6790.	6687.
	INCREASE OR DECREASE IN TAX	–706.	–725.	–625.	–525.	–325.	–23.
40000	CURRENT TAX (1966 RATES)	11955.	11820.	11685.	11550.	11280.	10875.
	TAX UNDER OUR PROPOSALS	10868.	10715.	10683.	10650.	10585.	10488.
	INCREASE OR DECREASE IN TAX	–1087.	–1105.	–1002.	–900.	–695.	–387.
50000	CURRENT TAX (1966 RATES)	16670.	16520.	16370.	16220.	15920.	15470.
	TAX UNDER OUR PROPOSALS	15046.	14896.	14866.	14837.	14777.	14688.
	INCREASE OR DECREASE IN TAX	–1624.	–1624.	–1504.	–1383.	–1143.	–782.
70000	CURRENT TAX (1966 RATES)	26540.	26375.	26210.	26045.	25715.	25220.
	TAX UNDER OUR PROPOSALS	24024.	23877.	23850.	23823.	23770.	23689.
	INCREASE OR DECREASE IN TAX	–2516.	–2498.	–2360.	–2222.	–1945.	–1531.
100000	CURRENT TAX (1966 RATES)	42630.	42450.	42270.	42090.	41730.	41190.
	TAX UNDER OUR PROPOSALS	38407.	38263.	38238.	38213.	38164.	38090.
	INCREASE OR DECREASE IN TAX	–4223.	–4187.	–4032.	–3877.	–3566.	–3100.
200000	CURRENT TAX (1966 RATES)	103160.	102950.	102740.	102530.	102110.	101480.
	TAX UNDER OUR PROPOSALS	88402.	88258.	88234.	88210.	88162.	88090.
	INCREASE OR DECREASE IN TAX	–14758.	–14692.	–14506.	–14320.	–13948.	–13390.

Note: See Assumptions in Appendix I.

TABLE I, 3-2

EFFECTIVE AVERAGE TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS FOR A FAMILY UNIT WITH 35 PER CENT OF ITS INCOME FROM A WORKING WIFE

GROSS EMPLOYMENT INCOME		STATUS OF TAXPAYER — MARRIED COUPLE — NUMBER OF CHILDREN					
		0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.000	0.000	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	0.000	0.000	0.000	0.000	0.000	0.000
2000	CURRENT TAX (1966 RATES)	0.000	0.000	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	0.000	0.000	0.000	0.000	0.000	0.000
2500	CURRENT TAX (1966 RATES)	0.008	0.000	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.014	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	0.007	0.000	0.000	0.000	0.000	0.000
3000	CURRENT TAX (1966 RATES)	0.028	0.015	0.002	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.033	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	0.005	−0.015	−0.002	0.000	0.000	0.000
3500	CURRENT TAX (1966 RATES)	0.049	0.036	0.025	0.014	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.049	0.001	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	0.000	−0.035	−0.025	−0.014	0.000	0.000
4000	CURRENT TAX (1966 RATES)	0.065	0.051	0.038	0.029	0.010	0.000
	TAX UNDER OUR PROPOSALS	0.062	0.020	0.008	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.002	−0.031	−0.030	−0.029	−0.010	0.000
5000	CURRENT TAX (1966 RATES)	0.085	0.073	0.062	0.052	0.033	0.010
	TAX UNDER OUR PROPOSALS	0.084	0.051	0.041	0.032	0.013	0.000
	CHANGE IN EFFECTIVE RATE	−0.001	−0.022	−0.021	−0.020	−0.020	−0.010
6500	CURRENT TAX (1966 RATES)	0.108	0.099	0.089	0.080	0.062	0.038
	TAX UNDER OUR PROPOSALS	0.107	0.082	0.075	0.068	0.054	0.033
	CHANGE IN EFFECTIVE RATE	−0.001	−0.017	−0.015	−0.012	−0.008	−0.005
8000	CURRENT TAX (1966 RATES)	0.123	0.116	0.109	0.102	0.086	0.064
	TAX UNDER OUR PROPOSALS	0.124	0.103	0.097	0.092	0.080	0.063
	CHANGE IN EFFECTIVE RATE	0.000	−0.013	−0.012	−0.010	−0.006	−0.001
10000	CURRENT TAX (1966 RATES)	0.141	0.135	0.128	0.121	0.108	0.091
	TAX UNDER OUR PROPOSALS	0.139	0.123	0.118	0.114	0.105	0.092
	CHANGE IN EFFECTIVE RATE	−0.002	−0.012	−0.010	−0.008	−0.004	0.001
12000	CURRENT TAX (1966 RATES)	0.156	0.149	0.143	0.137	0.126	0.110
	TAX UNDER OUR PROPOSALS	0.151	0.138	0.134	0.130	0.123	0.112
	CHANGE IN EFFECTIVE RATE	−0.005	−0.012	−0.009	−0.007	−0.003	0.003
15000	CURRENT TAX (1966 RATES)	0.174	0.168	0.162	0.157	0.146	0.131
	TAX UNDER OUR PROPOSALS	0.167	0.156	0.153	0.151	0.145	0.137
	CHANGE IN EFFECTIVE RATE	−0.007	−0.012	−0.008	−0.006	−0.001	0.006
20000	CURRENT TAX (1966 RATES)	0.203	0.198	0.193	0.187	0.177	0.162
	TAX UNDER OUR PROPOSALS	0.191	0.183	0.181	0.179	0.175	0.169
	CHANGE IN EFFECTIVE RATE	−0.012	−0.015	−0.011	−0.008	−0.002	0.007
25000	CURRENT TAX (1966 RATES)	0.233	0.228	0.223	0.218	0.208	0.194
	TAX UNDER OUR PROPOSALS	0.214	0.208	0.206	0.205	0.202	0.197
	CHANGE IN EFFECTIVE RATE	−0.018	−0.020	−0.016	−0.013	−0.006	0.003
30000	CURRENT TAX (1966 RATES)	0.260	0.255	0.251	0.246	0.237	0.224
	TAX UNDER OUR PROPOSALS	0.236	0.231	0.230	0.229	0.226	0.223
	CHANGE IN EFFECTIVE RATE	−0.024	−0.024	−0.021	−0.017	−0.011	−0.001
40000	CURRENT TAX (1966 RATES)	0.299	0.295	0.292	0.289	0.282	0.272
	TAX UNDER OUR PROPOSALS	0.272	0.268	0.267	0.266	0.265	0.262
	CHANGE IN EFFECTIVE RATE	−0.027	−0.028	−0.025	−0.022	−0.017	−0.010
50000	CURRENT TAX (1966 RATES)	0.333	0.330	0.327	0.324	0.318	0.309
	TAX UNDER OUR PROPOSALS	0.301	0.298	0.297	0.297	0.296	0.294
	CHANGE IN EFFECTIVE RATE	−0.032	−0.032	−0.030	−0.028	−0.023	−0.016
70000	CURRENT TAX (1966 RATES)	0.379	0.377	0.374	0.372	0.367	0.360
	TAX UNDER OUR PROPOSALS	0.343	0.341	0.341	0.340	0.340	0.338
	CHANGE IN EFFECTIVE RATE	−0.036	−0.036	−0.034	−0.032	−0.028	−0.022
100000	CURRENT TAX (1966 RATES)	0.426	0.424	0.423	0.421	0.417	0.412
	TAX UNDER OUR PROPOSALS	0.384	0.383	0.382	0.382	0.382	0.381
	CHARGE IN EFFECTIVE RATE	−0.042	−0.042	−0.040	−0.039	−0.036	−0.031
200000	CURRENT TAX (1966 RATES)	0.516	0.515	0.514	0.513	0.511	0.507
	TAX UNDER OUR PROPOSALS	0.442	0.441	0.441	0.441	0.441	0.440
	CHANGE IN EFFECTIVE RATE	−0.074	−0.073	−0.073	−0.072	−0.070	−0.067

Note: See assumptions in Appendix I.

TABLE I, 3–3

EFFECTIVE MARGINAL TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS FOR A FAMILY UNIT WITH 35 PER CENT OF ITS INCOME FROM A WORKING WIFE

GROSS EMPLOYMENT INCOME		STATUS OF TAXPAYER: MARRIED COUPLE — NUMBER OF CHILDREN 0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.000	0.000	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	0.000	0.000	0.000	0.000	0.000	0.000
2000	CURRENT TAX (1966 RATES)	0.038	0.000	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.071	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	0.033	0.000	0.000	0.000	0.000	0.000
2500	CURRENT TAX (1966 RATES)	0.128	0.090	0.013	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.126	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.002	−0.090	−0.013	0.000	0.000	0.000
3000	CURRENT TAX (1966 RATES)	0.180	0.160	0.160	0.096	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.147	0.007	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.033	−0.153	−0.160	−0.096	0.000	0.000
3500	CURRENT TAX (1966 RATES)	0.171	0.159	0.134	0.134	0.077	0.000
	TAX UNDER OUR PROPOSALS	0.155	0.155	0.066	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.016	−0.004	−0.069	−0.134	−0.077	0.000
4000	CURRENT TAX (1966 RATES)	0.162	0.162	0.155	0.129	0.128	0.006
	TAX UNDER OUR PROPOSALS	0.168	0.171	0.174	0.145	0.000	0.000
	CHANGE IN MARGINAL RATE	0.006	0.009	0.018	0.016	−0.128	−0.006
5000	CURRENT TAX (1966 RATES)	0.181	0.172	0.162	0.162	0.131	0.128
	TAX UNDER OUR PROPOSALS	0.180	0.182	0.183	0.184	0.184	0.041
	CHANGE IN MARGINAL RATE	−0.001	0.009	0.021	0.022	0.053	−0.087
6500	CURRENT TAX (1966 RATES)	0.186	0.193	0.199	0.199	0.180	0.171
	TAX UNDER OUR PROPOSALS	0.194	0.194	0.194	0.194	0.194	0.194
	CHANGE IN MARGINAL RATE	0.007	0.000	−0.005	−0.005	0.014	0.023
8000	CURRENT TAX (1966 RATES)	0.026	0.194	0.186	0.186	0.199	0.181
	TAX UNDER OUR PROPOSALS	0.198	0.199	0.201	0.202	0.204	0.204
	CHANGE IN MARGINAL RATE	−0.008	0.005	0.014	0.016	0.004	0.022
10000	CURRENT TAX (1966 RATES)	0.216	0.216	0.216	0.216	0.210	0.187
	TAX UNDER OUR PROPOSALS	0.206	0.208	0.209	0.211	0.213	0.213
	CHANGE IN MARGINAL RATE	−0.010	−0.009	−0.007	−0.006	0.003	0.027
12000	CURRENT TAX (1966 RATES)	0.235	0.235	0.235	0.219	0.209	0.209
	TAX UNDER OUR PROPOSALS	0.216	0.219	0.222	0.225	0.231	0.233
	CHANGE IN MARGINAL RATE	−0.019	−0.016	−0.013	0.006	0.021	0.023
15000	CURRENT TAX (1966 RATES)	0.272	0.272	0.272	0.252	0.246	0.246
	TAX UNDER OUR PROPOSALS	0.233	0.236	0.241	0.245	0.253	0.262
	CHANGE IN MARGINAL RATE	−0.039	−0.036	−0.031	−0.007	0.008	0.016
20000	CURRENT TAX (1966 RATES)	0.333	0.310	0.310	0.310	0.310	0.278
	TAX UNDER OUR PROPOSALS	0.270	0.272	0.278	0.283	0.295	0.310
	CHANGE IN MARGINAL RATE	−0.063	−0.039	−0.033	−0.027	−0.016	0.032
25000	CURRENT TAX (1966 RATES)	0.383	0.368	0.351	0.351	0.351	0.351
	TAX UNDER OUR PROPOSALS	0.310	0.312	0.318	0.323	0.335	0.350
	CHANGE IN MARGINAL RATE	−0.073	−0.057	−0.033	−0.028	−0.016	−0.001
30000	CURRENT TAX (1966 RATES)	0.397	0.397	0.397	0.397	0.397	0.397
	TAX UNDER OUR PROPOSALS	0.350	0.351	0.356	0.360	0.369	0.380
	CHANGE IN MARGINAL RATE	−0.047	−0.046	−0.042	−0.038	−0.029	−0.017
40000	CURRENT TAX (1966 RATES)	0.455	0.432	0.432	0.432	0.432	0.432
	TAX UNDER OUR PROPOSALS	0.380	0.382	0.388	0.393	0.405	0.420
	CHANGE IN MARGINAL RATE	−0.075	−0.051	−0.045	−0.039	−0.028	−0.012
50000	CURRENT TAX (1966 RATES)	0.482	0.482	0.482	0.482	0.482	0.482
	TAX UNDER OUR PROPOSALS	0.420	0.421	0.424	0.427	0.432	0.440
	CHANGE IN MARGINAL RATE	−0.063	−0.062	−0.059	−0.056	−0.050	−0.043
70000	CURRENT TAX (1966 RATES)	0.515	0.515	0.515	0.515	0.515	0.515
	TAX UNDER OUR PROPOSALS	0.460	0.460	0.460	0.460	0.460	0.460
	CHANGE IN MARGINAL RATE	−0.055	−0.055	−0.055	−0.055	−0.055	−0.055
100000	CURRENT TAX (1966 RATES)	0.565	0.565	0.565	0.565	0.565	0.565
	TAX UNDER OUR PROPOSALS	0.490	0.490	0.492	0.493	0.496	0.500
	CHANGE IN MARGINAL RATE	−0.075	−0.075	−0.073	−0.072	−0.069	−0.065
200000	CURRENT TAX (1966 RATES)	0.665	0.665	0.665	0.665	0.665	0.665
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	−0.165	−0.165	−0.165	−0.165	−0.165	−0.165

Note: See Assumptions in Appendix I.

TABLE I, 4-1

CHANGES IN TAX LIABILITIES UNDER THE PROPOSED TAX SYSTEM FOR A FAMILY UNIT WITH 50 PER CENT OF ITS INCOME FROM A WORKING WIFE

GROSS EMPLOYMENT INCOME		STATUS OF TAXPAYER					
		MARRIED COUPLE					
		NUMBER OF CHILDREN					
		0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.	0.	0.	0.	0.	0.
	TAX UNDER OUR PROPOSALS	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	0.	0.	0.	0.	0.	0.
2000	CURRENT TAX (1966 RATES)	0.	0.	0.	0.	0.	0.
	TAX UNDER OUR PROPOSALS	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	0.	0.	0.	0.	0.	0.
2500	CURRENT TAX (1966 RATES)	38.	19.	0.	0.	0.	0.
	TAX UNDER OUR PROPOSALS	36.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–3.	–19.	0.	0.	0.	0.
3000	CURRENT TAX (1966 RATES)	102.	64.	26.	13.	0.	0.
	TAX UNDER OUR PROPOSALS	99.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–4.	–64.	–26.	–13.	0.	0.
3500	CURRENT TAX (1966 RATES)	166.	128.	90.	51.	6.	0.
	TAX UNDER OUR PROPOSALS	172.	4.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	6.	–124.	–90.	–51.	–6.	0.
4000	CURRENT TAX (1966 RATES)	230.	192.	154.	115.	38.	0.
	TAX UNDER OUR PROPOSALS	250.	81.	33.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	19.	–111.	–121.	–115.	–38.	0.
5000	CURRENT TAX (1966 RATES)	404.	350.	296.	250.	166.	51.
	TAX UNDER OUR PROPOSALS	421.	254.	207.	160.	67.	0.
	INCREASE OR DECREASE IN TAX	17.	–96.	–89.	–90.	–99.	–51.
6500	CURRENT TAX (1966 RATES)	683.	624.	566.	512.	404.	245.
	TAX UNDER OUR PROPOSALS	698.	532.	487.	441.	350.	213.
	INCREASE OR DECREASE IN TAX	15.	–92.	–79.	–71.	–54.	–32.
8000	CURRENT TAX (1966 RATES)	998.	935.	872.	809.	683.	512.
	TAX UNDER OUR PROPOSALS	989.	823.	778.	732.	642.	507.
	INCREASE OR DECREASE IN TAX	–9.	–112.	–94.	–77.	–41.	–5.
10000	CURRENT TAX (1966 RATES)	1382.	1325.	1268.	1211.	1085.	908.
	TAX UNDER OUR PROPOSALS	1393.	1229.	1184.	1139.	1049.	917.
	INCREASE OR DECREASE IN TAX	12.	–96.	–84.	–72.	–36.	9.
12000	CURRENT TAX (1966 RATES)	1816.	1750.	1684.	1618.	1486.	1306.
	TAX UNDER OUR PROPOSALS	1817.	1653.	1608.	1564.	1476.	1347.
	INCREASE OR DECREASE IN TAX	1.	–97.	–76.	–54.	–10.	41.
15000	CURRENT TAX (1966 RATES)	2508.	2430.	2352.	2282.	2146.	1948.
	TAX UNDER OUR PROPOSALS	2507.	2344.	2302.	2259.	2173.	2048.
	INCREASE OR DECREASE IN TAX	–1.	–86.	–50.	–23.	27.	100.
20000	CURRENT TAX (1966 RATES)	3880.	3790.	3700.	3610.	3430.	3184.
	TAX UNDER OUR PROPOSALS	3828.	3668.	3627.	3587.	3506.	3385.
	INCREASE OR DECREASE IN TAX	–52.	–122.	–73.	–23.	76.	201.
25000	CURRENT TAX (1966 RATES)	5520.	5415.	5310.	5205.	4995.	4680.
	TAX UNDER OUR PROPOSALS	5356.	5199.	5161.	5123.	5048.	4936.
	INCREASE OR DECREASE IN TAX	–164.	–216.	–149.	–82.	53.	256.
30000	CURRENT TAX (1966 RATES)	7460.	7340.	7220.	7100.	6860.	6500.
	TAX UNDER OUR PROPOSALS	7084.	6930.	6895.	6860.	6790.	6687.
	INCREASE OR DECREASE IN TAX	–376.	–410.	–325.	–240.	–70.	187.
40000	CURRENT TAX (1966 RATES)	11850.	11715.	11580.	11445.	11175.	10770.
	TAX UNDER OUR PROPOSALS	10868.	10715.	10683.	10650.	10585.	10488.
	INCREASE OR DECREASE IN TAX	–982.	–1000.	–897.	–795.	–590.	–282.
50000	CURRENT TAX (1966 RATES)	16350.	16215.	16080.	15945.	15675.	15270.
	TAX UNDER OUR PROPOSALS	15046.	14896.	14866.	14837.	14777.	14688.
	INCREASE OR DECREASE IN TAX	–1304.	–1319.	–1214.	–1108.	–898.	–582.
70000	CURRENT TAX (1966 RATES)	26240.	26090.	25940.	25790.	25490.	25040.
	TAX UNDER OUR PROPOSALS	24024.	23877.	23850.	23823.	23770.	23689.
	INCREASE OR DECREASE IN TAX	–2216.	–2213.	–2090.	–1967.	–1720.	–1351.
100000	CURRENT TAX (1966 RATES)	42130.	41965.	41800.	41635.	41305.	40810.
	TAX UNDER OUR PROPOSALS	38407.	38263.	38238.	38213.	38164.	38090.
	INCREASE OR DECREASE IN TAX	–3723.	–3702.	–3562.	–3422.	–3141.	–2720.
200000	CURRENT TAX (1966 RATES)	101910.	101715.	101520.	101325.	100935.	100350.
	TAX UNDER OUR PROPOSALS	88402.	88258.	88234.	88210.	88162.	88090.
	INCREASE OR DECREASE IN TAX	–13508.	–13457.	–13286.	–13115.	–12773.	–12260.

Note: See assumptions in Appendix I.

TABLE I, 4-2

EFFECTIVE AVERAGE TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS FOR A FAMILY UNIT WITH 50 PER CENT OF ITS INCOME FROM A WORKING WIFE

GROSS EMPLOYMENT INCOME		STATUS OF TAXPAYER: MARRIED COUPLE — NUMBER OF CHILDREN					
		0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.000	0.000	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	0.000	0.000	0.000	0.000	0.000	0.000
2000	CURRENT TAX (1966 RATES)	0.000	0.000	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	0.000	0.000	0.000	0.000	0.000	0.000
2500	CURRENT TAX (1966 RATES)	0.015	0.008	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.014	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.001	-0.008	0.000	0.000	0.000	0.000
3000	CURRENT TAX (1966 RATES)	0.034	0.021	0.009	0.004	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.033	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.001	-0.021	-0.009	-0.004	0.000	0.000
3500	CURRENT TAX (1966 RATES)	0.048	0.037	0.026	0.015	0.002	0.000
	TAX UNDER OUR PROPOSALS	0.049	0.001	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	0.002	-0.036	-0.026	-0.015	-0.002	0.000
4000	CURRENT TAX (1966 RATES)	0.058	0.048	0.038	0.029	0.010	0.000
	TAX UNDER OUR PROPOSALS	0.062	0.020	0.008	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	0.005	-0.028	-0.030	-0.029	-0.010	0.000
5000	CURRENT TAX (1966 RATES)	0.081	0.070	0.059	0.050	0.033	0.010
	TAX UNDER OUR PROPOSALS	0.084	0.051	0.041	0.032	0.013	0.000
	CHANGE IN EFFECTIVE RATE	0.003	-0.019	-0.018	-0.018	-0.020	-0.010
6500	CURRENT TAX (1966 RATES)	0.105	0.096	0.087	0.079	0.062	0.038
	TAX UNDER OUR PROPOSALS	0.107	0.082	0.075	0.068	0.054	0.033
	CHANGE IN EFFECTIVE RATE	0.002	-0.014	-0.012	-0.011	-0.008	-0.005
8000	CURRENT TAX (1966 RATES)	0.125	0.117	0.109	0.101	0.085	0.064
	TAX UNDER OUR PROPOSALS	0.124	0.103	0.097	0.092	0.080	0.063
	CHANGE IN EFFECTIVE RATE	-0.001	-0.014	-0.012	-0.010	-0.005	-0.001
10000	CURRENT TAX (1966 RATES)	0.138	0.132	0.127	0.121	0.108	0.091
	TAX UNDER OUR PROPOSALS	0.139	0.123	0.118	0.114	0.105	0.092
	CHANGE IN EFFECTIVE RATE	0.001	-0.010	-0.008	-0.007	-0.004	-0.001
12000	CURRENT TAX (1966 RATES)	0.151	0.146	0.140	0.135	0.124	0.109
	TAX UNDER OUR PROPOSALS	0.151	0.138	0.134	0.130	0.123	0.112
	CHANGE IN EFFECTIVE RATE	0.000	-0.008	-0.006	-0.004	-0.001	0.003
15000	CURRENT TAX (1966 RATES)	0.167	0.162	0.157	0.152	0.143	0.130
	TAX UNDER OUR PROPOSALS	0.167	0.156	0.153	0.151	0.145	0.137
	CHANGE IN EFFECTIVE RATE	0.000	-0.006	-0.003	-0.002	0.002	0.007
20000	CURRENT TAX (1966 RATES)	0.194	0.189	0.185	0.180	0.171	0.159
	TAX UNDER OUR PROPOSALS	0.191	0.183	0.181	0.179	0.175	0.169
	CHANGE IN EFFECTIVE RATE	-0.003	-0.006	-0.004	-0.001	0.004	0.010
25000	CURRENT TAX (1966 RATES)	0.221	0.217	0.212	0.208	0.200	0.187
	TAX UNDER OUR PROPOSALS	0.214	0.208	0.206	0.205	0.202	0.197
	CHANGE IN EFFECTIVE RATE	-0.007	-0.009	-0.006	-0.003	0.002	0.010
30000	CURRENT TAX (1966 RATES)	0.249	0.245	0.241	0.237	0.229	0.217
	TAX UNDER OUR PROPOSALS	0.236	0.231	0.230	0.229	0.226	0.223
	CHANGE IN EFFECTIVE RATE	-0.013	-0.014	-0.011	-0.008	-0.002	0.006
40000	CURRENT TAX (1966 RATES)	0.296	0.293	0.289	0.286	0.279	0.269
	TAX UNDER OUR PROPOSALS	0.272	0.268	0.267	0.266	0.265	0.262
	CHANGE IN EFFECTIVE RATE	-0.025	-0.025	-0.022	-0.020	-0.015	-0.007
50000	CURRENT TAX (1966 RATES)	0.327	0.324	0.322	0.319	0.313	0.305
	TAX UNDER OUR PROPOSALS	0.301	0.298	0.297	0.297	0.296	0.294
	CHANGE IN EFFECTIVE RATE	-0.026	-0.026	-0.024	-0.022	-0.018	-0.012
70000	CURRENT TAX (1966 RATES)	0.375	0.373	0.371	0.368	0.364	0.358
	TAX UNDER OUR PROPOSALS	0.343	0.341	0.341	0.340	0.340	0.338
	CHANGE IN EFFECTIVE RATE	-0.032	-0.032	-0.030	-0.028	-0.025	-0.019
100000	CURRENT TAX (1966 RATES)	0.421	0.420	0.418	0.416	0.413	0.408
	TAX UNDER OUR PROPOSALS	0.384	0.383	0.382	0.382	0.382	0.381
	CHANGE IN EFFECTIVE RATE	-0.037	-0.037	-0.036	-0.034	-0.031	-0.027
200000	CURRENT TAX (1966 RATES)	0.510	0.509	0.508	0.507	0.505	0.502
	TAX UNDER OUR PROPOSALS	0.442	0.441	0.441	0.441	0.441	0.440
	CHANGE IN EFFECTIVE RATE	-0.068	-0.067	-0.066	-0.066	-0.064	-0.061

Note: See Assumptions in Appendix I.

TABLE I, 4-3

EFFECTIVE MARGINAL TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS FOR A FAMILY UNIT WITH 50 PER CENT OF ITS INCOME FROM A WORKING WIFE

GROSS EMPLOYMENT INCOME		STATUS OF TAXPAYER					
		MARRIED COUPLE					
		NUMBER OF CHILDREN					
		0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.000	0.000	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	0.000	0.000	0.000	0.000	0.000	0.000
2000	CURRENT TAX (1966 RATES)	0.077	0.038	0.000	0.000	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.071	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.005	−0.038	0.000	0.000	0.000	0.000
2500	CURRENT TAX (1966 RATES)	0.128	0.090	0.051	0.026	0.000	0.000
	TAX UNDER OUR PROPOSALS	0.126	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.002	−0.090	−0.051	−0.026	0.000	0.000
3000	CURRENT TAX (1966 RATES)	0.128	0.128	0.128	0.077	0.013	0.000
	TAX UNDER OUR PROPOSALS	0.147	0.007	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	0.019	−0.121	−0.128	−0.077	−0.013	0.000
3500	CURRENT TAX (1966 RATES)	0.128	0.128	0.128	0.128	0.064	0.000
	TAX UNDER OUR PROPOSALS	0.155	0.155	0.066	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	0.027	0.027	−0.062	−0.128	−0.064	0.000
4000	CURRENT TAX (1966 RATES)	0.167	0.148	0.128	0.128	0.128	0.000
	TAX UNDER OUR PROPOSALS	0.168	0.171	0.174	0.145	0.000	0.000
	CHANGE IN MARGINAL RATE	0.001	0.023	0.046	0.017	−0.128	0.000
5000	CURRENT TAX (1966 RATES)	0.180	0.180	0.180	0.163	0.137	0.128
	TAX UNDER OUR PROPOSALS	0.180	0.182	0.183	0.184	0.184	0.041
	CHANGE IN MARGINAL RATE	0.000	0.002	0.003	0.021	0.047	−0.087
6500	CURRENT TAX (1966 RATES)	0.210	0.201	0.192	0.186	0.180	0.174
	TAX UNDER OUR PROPOSALS	0.194	0.194	0.194	0.194	0.194	0.194
	CHANGE IN MARGINAL RATE	−0.016	−0.007	0.002	0.008	0.014	0.020
8000	CURRENT TAX (1966 RATES)	0.198	0.204	0.204	0.204	0.210	0.180
	TAX UNDER OUR PROPOSALS	0.198	0.199	0.201	0.202	0.204	0.204
	CHANGE IN MARGINAL RATE	0.000	−0.005	−0.003	−0.002	−0.006	0.024
10000	CURRENT TAX (1966 RATES)	0.208	0.199	0.190	0.190	0.209	0.188
	TAX UNDER OUR PROPOSALS	0.206	0.208	0.209	0.211	0.213	0.213
	CHANGE IN MARGINAL RATE	−0.002	0.009	0.019	0.021	0.004	0.025
12000	CURRENT TAX (1966 RATES)	0.220	0.220	0.220	0.220	0.220	0.190
	TAX UNDER OUR PROPOSALS	0.216	0.219	0.222	0.225	0.231	0.233
	CHANGE IN MARGINAL RATE	−0.004	−0.001	0.002	0.005	0.011	0.043
15000	CURRENT TAX (1966 RATES)	0.260	0.260	0.260	0.244	0.224	0.220
	TAX UNDER OUR PROPOSALS	0.233	0.236	0.241	0.245	0.253	0.262
	CHANGE IN MARGINAL RATE	−0.027	−0.024	−0.019	0.001	0.030	0.042
20000	CURRENT TAX (1966 RATES)	0.300	0.300	0.300	0.300	0.300	0.260
	TAX UNDER OUR PROPOSALS	0.270	0.272	0.278	0.283	0.295	0.310
	CHANGE IN MARGINAL RATE	−0.030	−0.028	−0.022	−0.017	−0.005	0.050
25000	CURRENT TAX (1966 RATES)	0.350	0.350	0.350	0.350	0.350	0.350
	TAX UNDER OUR PROPOSALS	0.310	0.312	0.318	0.323	0.335	0.350
	CHANGE IN MARGINAL RATE	−0.040	−0.038	−0.032	−0.027	−0.015	0.000
30000	CURRENT TAX (1966 RATES)	0.400	0.400	0.400	0.400	0.400	0.400
	TAX UNDER OUR PROPOSALS	0.350	0.351	0.356	0.360	0.369	0.380
	CHANGE IN MARGINAL RATE	−0.050	−0.049	−0.044	−0.040	−0.031	−0.020
40000	CURRENT TAX (1966 RATES)	0.450	0.450	0.450	0.450	0.450	0.450
	TAX UNDER OUR PROPOSALS	0.380	0.382	0.388	0.393	0.405	0.420
	CHANGE IN MARGINAL RATE	−0.070	−0.068	−0.062	−0.057	−0.045	−0.030
50000	CURRENT TAX (1966 RATES)	0.450	0.450	0.450	0.450	0.450	0.450
	TAX UNDER OUR PROPOSALS	0.420	0.421	0.424	0.427	0.432	0.440
	CHANGE IN MARGINAL RATE	−0.030	−0.029	−0.026	−0.023	−0.018	−0.010
70000	CURRENT TAX (1966 RATES)	0.500	0.500	0.500	0.500	0.500	0.500
	TAX UNDER OUR PROPOSALS	0.460	0.460	0.460	0.460	0.460	0.460
	CHANGE IN MARGINAL RATE	−0.040	−0.040	−0.040	−0.040	−0.040	−0.040
100000	CURRENT TAX (1966 RATES)	0.550	0.550	0.550	0.550	0.550	0.550
	TAX UNDER OUR PROPOSALS	0.490	0.490	0.492	0.493	0.496	0.500
	CHANGE IN MARGINAL RATE	−0.060	−0.060	−0.058	−0.057	−0.054	−0.050
200000	CURRENT TAX (1966 RATES)	0.650	0.650	0.650	0.650	0.650	0.650
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	−0.150	−0.150	−0.150	−0,150	−0.150	−0.150

Note: See assumptions in Appendix I.

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